

The Political Economic Dimensions of Executive Compensation
Reform: Can the Foundations of Shareholder Primacy Be Sustained in
the Post-Crisis Regulatory Environment?

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Abstract

What is absent in much of the literature on executive compensation reform is a deeper appreciation of the shift that has occurred since the latest financial crisis away from performance-based corporate governance arrangements to an approach that seeks to put the brakes on a runaway train, the shareholder value model and its relentless pursuit of shareholder wealth at all costs. By situating this debate into a broader discussion of corporate purpose, corporate governance and the law's role in how business corporations are run in their social, economic and political environment this project seeks to shed some light onto what really is at stake in this debate, whether the existing shareholder primacy paradigm for conceptualizing and fashioning a solution for constraining managerial power in the firm is a viable solution moving forward from the crisis.

Dedication

I dedicate this thesis to my family, especially my wife who tolerated my endless hours of research and study and to my children Dez Jr. and Zora who inspire me every day.

Acknowledgments

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CHAPTER ONE:

Introduction

“In the day of the free market, where our country was the top industrial power, there was accountability to the stockholder...because it was their money at stake...today, management has no stake in the company...altogether, these men up here [referring to directors and managers], own less than 3% of the company...you own the company...that’s right, you the stockholder, you are being royally screwed over by these bureaucrats, with their estate palaces, their hunting and fishing trips, their corporate jets and golden parachutes...the new law in corporate America seems to be survival of the un-fittest...well in my book, you either do it right or get eliminated...I am not a destroyer of companies, I am a liberator of them...the point is ladies and gentlemen, that greed, for lack of better words, is good.” (Gordon Gekko, 1987, Wall Street The Movie)

SECTION A

Almost five years have passed since the global financial crisis began and many economies are still feeling its devastating effects. In addition to slower than anticipated economic recovery in the United States, it is unclear what lessons if any were learned in the corporate governance realm and whether changes implemented in the wake of the crisis had any substantive impact on lowering risk-taking and encouraging firm sustainability. When the US economy does eventually recover, we will again be faced with the question of how the next scandal or crisis can be averted. It is crucial not to let recent history casually slip by and to further avail ourselves of the opportunity for learning and reform.

Being at centre stage of the regulatory narrative that unfolded after the crisis, the story of executive compensation in the liberal market context has remained relatively unchanged. While CEO pay in the US remains staggeringly high, other market economies have seen a stabilization of pay levels and a recent trend towards reforming developments which previously militated towards US style, market-driven compensation packages. Germany is just one example where executive compensation has been tied to the sustainability of the corporation and amongst other things has incorporated the interests of other groups that are essential to the firm's success and to the smooth functioning of the broader political economy. Consequently Germany has emerged as an economic leader on the European scene in light of Europe's deep financial troubles.

While the crisis presented a multitude of opportunities to further advance the case against shareholder primacy, the executive compensation debate never quite escaped the confines of agency theory, as the dominant analytical framework. Even with the staggering blows dealt by progressive corporate law scholarship to shareholder primacy's cause, the compensation debate continues to be framed from this perspective, reproducing a narrow set of discourses that have yielded relatively limited results.

What is absent in much of the literature on executive compensation reform is a deeper appreciation of the shift that has occurred since the latest financial crisis away from performance-based corporate governance arrangements to an approach that seeks to put the brakes on a runaway train, the shareholder value model and its relentless pursuit of shareholder wealth at all costs. By situating this debate into a broader discussion of corporate purpose, corporate governance and the law's role in how business corporations are run in their social, economic and political environment this project seeks to shed some light onto what really is at stake in this debate, whether the existing shareholder primacy paradigm for conceptualizing and fashioning a solution for constraining managerial power in the firm is a viable solution moving forward from the crisis.

This work seeks to step outside the narrow law and economics paradigm from which executive compensation has been problematized since at least the 1990's. By disentangling the separate lines of argument inherent in the executive compensation debate and viewing these in a forum where their interrelation can be adequately assessed, we can highlight the various interests at play and the broader significance of how executive compensation has been problematized to critically assess whether the existing dominant paradigm can be sustained in light of the prospective changes to corporate governance that post crisis compensation reform has identified, mainly the need to operate large public corporations sustainably and in the public interest.

The broader dimensions of this debate can be assessed by first situating the parallel and sometimes competing narratives on executive compensation into a wider corporate legal framework. By then tracing the evolution of this framework and the compensation issue within it, we begin to see today's debate as a particular point in the trajectory of corporate law and how the firm is governed. The picture which emerges is one where the debate over compensation in the 1990's was at the centre of a key shift in governance thinking characterized by a drastic re-thinking of the business corporation's legal nature, the role that law should play and how the rights and

duties of actors are defined.

This shift is representative of competing views between the role that mandatory norms of behaviour should play versus the prospects of performance and efficiency based norms of governance. With the purported limitations of trust and loyalty based norms for solving the problem of managerial performance, the vulnerability of shareholders under the framework of corporate law and the putative inadequacies of corporate law's division of power, the shift to a performance-based model of governance is seen as a repudiation of corporate law's key attributes. Excessive executive pay is a symptom of these broader limitations and solutions within this paradigm for addressing it, namely by reducing its size and constraining profit-maximization, are seen as contributing to the ongoing set of problems facing shareholders.

Going further back however, it is crucial to understand the strengths and prospects of this model, and the previously articulated challenges of protecting society from the far-reaching effects of managerial power it was tasked with solving, as expressed in the post-Great Depression debate over who corporations should be run for. In this context we can gain an understanding of the role served by the existing division of power and legally and structurally entrenched Board discretion. We can then understand the larger corporate governance problem represented by executive pay in this context and only after assessing more broadly the strengths and weaknesses of this model can we approach the issue of what is going in the post-crisis context and how executive compensation has played a central role. Only then can we begin to see the consequences of shifting away from the former model and of overemphasizing the latter, how the gradual evolution of this approach led us to where we are now and how the goals that each approach seeks to achieve conflict, with significant consequences for corporate governance.

Yet the lens for assessing the current state of corporate governance is not complete. Building on this historical corporate legal analysis comparative political economy necessarily allows us to further broaden the scope of inquiry, this time revealing the contentious relationships and political contestations between the interests of actors inherent in the differing approaches to constraining managerial power and to conceptualizing the legal nature of the firm.

What begins to emerge is not only a bigger picture of the executive compensation debate as a political contest between economic actors over who's interests the firm should run in and how the risks and benefits of economic activity distributed, but also a contest between broader political

forces of finance and labour over instituting the self-regulating market versus measures aimed at social protection. This enlarged perspective of the compensation debate allows us to engage with neo-classical economic assumptions which underpin the existing debate and make it challenging to step outside of it and critique compensation from any other perspective, other than to adjust and improve the various performance-based mechanisms from within the framework to avoid another crisis.

In many respects the status quo approach to compensation reform which entails working within this paradigm represents the fundamental point of contention over how our system of political economy should be organized and which improvements to it will ultimately prevail. It is crucial to step outside this box and assess whether the latest crisis and the role that our current approach to corporate governance has played in it, namely through executive pay, has highlighted the inherent shortcomings of the model's current place in its trajectory.

Thus the other role of comparative political economy in shedding light on the current state of affairs is to help broaden our understanding of the impetus behind and consequences of the previous shift to a more liberal form of market capitalism, the limitation of the approach before, and the prospects and limitations of the existing approach. This culminates in the question, “how far can liberal market capitalism be ultimately pushed before it breaks and are we at that point with the current state of corporate governance?”

The final step then to complete this assessment is to look beyond common, technically based distinctions of rules versus principles based regulation to gain a deeper understanding of what post-crisis regulatory responses represent and how differences in the approaches of two major economies, the United States and Germany can be accounted for. Examining their responses to the crisis in light of how these changes stand to impact the management orientations of some of the world's largest corporations, reveals in certain respects that the shareholder primacy based paradigm is incapable of carrying out what post-crisis reform is calling for, to run public corporations sustainably for the benefit of shareholders as well as in the public interest. A more balanced approach is needed within the liberal market context between emphasizing the profit motive and constraining the actions of managers through legal norms of behaviour that are more inclusive of a wider set of interests.

SECTION B

The recent string of corporate scandals and crises that have plagued our economic systems have reminded us of the far reaching effects of corporate power on economic and social welfare and have highlighted the integral nature of the business corporation as an institution of contemporary capitalism. Like before, questions have been raised over what drives corporate decision-making and what influences a corporation's values and priorities. During the past two decades we have witnessed a progressive but influential shift in the role of the business corporation in Anglo-American society in the context a changing political economy marked by a shift from industrial to financial capitalism.¹ This in turn has cast a spotlight on the dynamic that exists between the various corporate constituents that influence and are impacted by the outcomes of corporate activity and in particular has highlighted that these interests are often juxtaposed in the contemporary context of financial capitalism. The trade-offs between these interests inherent in how business corporations have been managed recently draws attention to how the risks and benefits of corporate activity are managed and distributed amongst the corporation's various stakeholders and how this impacts our economic and social welfare. This coupled with the devastating effects of the most recent financial crisis prompts us urgently to re-evaluate the set of arrangements that have underpinned our economic systems.

At a fundamental level corporations are not only sites where economic actors coalesce to engage in exchange and voluntary contracting for the purposes of meeting their individual needs and achieving a collective set of economic goals but also organizations in civil society that wield tremendous amounts of power and influence over our individual and societal welfare.² In most industrialized democratic societies the state through its various organs has an interest in both the benefits that business corporations create such as innovation, employment, and the provision of valuable products and services and the potential harms caused by corporations to the commons and to the interests of those who contribute to and rely upon their success and continuity.³ The role of the state in this regard has varied from interpreting, mediating and enforcing the various contractual arrangements between corporate actors to facilitating and reinforcing processes for

¹ Sanford M. Jacoby, "Labor and finance in the United States" in Cynthia A. Williams and P. Zumbansen, *The Embedded Firm* (New York: Cambridge University Press, 2011).

² David Sciulli, *Corporate Power in Civil Society: An Application of Societal Constitutionalism* (New York: NYU Press, 2001).

³ *Ibid.*

corporate actors to follow and structure themselves by and finally to legislating the behavior of actors as a means of protecting the interests of a particular group.⁴

Corporate governance as both a study and a practice focuses on mediating the source of power in the corporation for the private benefit of those who contribute to and derive benefit from this type of organization and also for the protection of those who are impacted by the corporation's activities but are not direct participants in its governance.⁵ Corporate governance deals both with the practices engaged in by those who exercise power in the corporation and partake in its management and with the network of legal and economic factors that constrain or facilitate how these actors behave. From a broader perspective, corporate governance is a narrow yet decisively important aspect of how a political economy is organized and for that matter integrated into an increasingly interconnected global market society.⁶ In sum, the types of corporate governance arrangements present at the national level represent a particular set of solutions and compromises to the conflicts and tensions that arise between actors engaging within and around the business corporation in its contemporary context.⁷

The latest financial crisis demonstrates just how serious the implications of such economic arrangements can be not only at the national level but also trans-nationally as evidenced by the widespread effects of the financial meltdown in the U.S. banking sector and the unprecedented level of regulatory responses at the national and supranational levels aimed at correcting the perceived imbalances and deficiencies in how these arrangements are structured.⁸ This further highlights the integral role that such institutions play in our economic and social welfare and the necessity of properly balancing the need to facilitate the contribution and participation of a particular set of corporate actors with the need to constrain a particular range of behaviours of these actors in the course of their involvement in corporate activity. In the context of financial capitalism in much of Anglo-American world the balance not surprisingly has favoured the relentless pursuit of shareholder wealth at the expense of a wide range of other

⁴ Jacoby, *supra* note 1; Simon Deakin, "Corporate Governance and Financial Crisis in the Long-Run" in Cynthia A. Williams and P. Zumbansen, *The Embedded Firm* (New York: Cambridge University Press, 2011) 15-41; Kent Greenfield,

⁵ Sciulli, *supra* note 2; See also Melvin A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Washington DC: Beard Books, 1976).

⁶ See Klaus Hopt, Hideki Handa, Mark J. Roe, Wymeersch and Stefan Prigge eds., *Comparative Corporate Governance: The State of the Art in Emerging Research* (Oxford: Clarendon Press, 1998) at v.-ix.

⁷ *Ibid.*

⁸ Eilis Feran, Niamh Moloney, Jennifer G. Hill, John C. Coffee Jr., *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press: Cambridge UK, 2012).

interests.⁹

Executive compensation reform has been central to the post-crisis re-evaluation of corporate governance norms and practices.¹⁰ The crisis has revealed the importance of the executive compensation issue to deeper questions of how the firm should be run. Not only does executive compensation represent a set of governance arrangements that have particular consequences for how the risks and benefits of corporate activity are distributed but also how managerial power in the firm is constrained and to what end.¹¹ Executive compensations has played an important part of the equation of how a nation should approach and resolve the sets of issues that arise between the actors that are involved with, derive benefit from and contribute to the success of the business corporation in the context of its broader economic role. Executive compensation has the potential to act as a determinant of managerial behaviour and also serves as a mechanism for aligning the interests of corporate constituents into particular coalitions.¹² On this basis, it has been used as a corporate governance mechanism for constraining the managerial power in the public corporation where ownership and control out of necessity are separate.¹³ In sum, getting the compensation issue right is crucial to averting another crisis.

⁹ Stout, *infra* note 16.

¹⁰ See Hill, *supra* note 8.

¹¹ See Jacoby, *supra* note 1.

¹² *Ibid.*

¹³ See Berle, *infra* note 188.

CHAPTER TWO:

The Current Debate of Compensation Reform and This Work's Contribution

SECTION A: What This Work Is Trying to Achieve

The post-crisis debate over executive compensation, as some have argued, represents a possible turning point for the shareholder primacy model of corporate governance and an indicator of this model's limitations.¹⁴ The aim of this work is to evaluate this premise. The key problems identified with the current state of compensation incentives aside from executive pay being excessive, are that compensation incentives aimed at increasing share price performance by stimulating greater risk taking and efficiency have led to chronic short-termism and excessive risk-taking in public corporations and more notably the financial sector, culminating in the collapse of systemically important financial institutions and leading perhaps to the greatest economic crisis since the Great Depression.¹⁵

Corporate law scholarship has dealt a significant blow to the shareholder value norm since the financial crisis.¹⁶ While several of these criticisms echo the weaknesses in governance that emerged after Enron, there are key differences in the post-crisis critique which strike to the heart of the current model's efficacy by challenging the prospects of self-regulation, performance based norms of conduct and the market as a governance tool.¹⁷ Yet the post-crisis re-evaluation of executive compensation in the US is still being framed predominantly from within the agency theory paradigm.¹⁸ The critique of the current approach has not extended this far, yet the development of executive compensation as governance tool is founded upon and inseparable

¹⁴ See Feran et al., *supra* note 8; See also Jennifer G. Hill, "Regulating executive remuneration after the global financial crisis: common law perspectives" in Randall S. Thomas and Jennifer G. Hill eds., *Research Handbook on Executive Pay* (Edward Elgar Publishing: UK, 2012) 219-240.

¹⁵ Jaap Winter, "Corporate Governance Going Astray: Executive Remuneration Built to Fail" in Randall S. Thomas and Jennifer G. Hill eds., *Research Handbook on Executive Pay* (Edward Elgar Publishing: UK, 2012) 199-218; Sanjai Bhagat and Roberta Romano, "Reforming Financial Executives' Compensation for the Long-Term" in in Randall S. Thomas and Jennifer G. Hill eds., *Research Handbook on Executive Pay* (Edward Elgar Publishing: UK, 2012) 136-158.

¹⁶ Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, the Corporation and the Public* (Berrett-Koehler Publishers: San Francisco, 2012).

¹⁷ See David Millon, "Enlightened shareholder value, social responsibility and the re-definition of corporate purpose without law" in P.M. Vasudev and Susan Watson, *Corporate Governance after the Financial Crisis* (Northampton: Edward Elgar, 2012) 68-100.

¹⁸ See Romano, *supra* note 15; see also Yannick Hausmann and Elisabeth Bechtold-Orth, "Changing Remuneration Systems in Europe and the United States: A Legal Analysis of Recent Developments in the Wake of the Financial Crisis" (2010) 11(2) *European Business Organization L R* 195.

from the shareholder primacy model and the shareholder value norm. If legislators, regulators and corporations themselves seek to develop and implement lasting reforms, it is imperative they examine compensation reform from outside this paradigm and not take for granted the foundations it rests upon might be poised to shift.

SECTION B: Problems with the Current Debate

The ongoing debate over compensation reform in the US is framed from an agency theory perspective which accepts shareholder primacy's efficacy and unproblematic continued existence.¹⁹ This entails the same intensity of reliance on capital markets and performance-based governance norms as before. Proponents of this model continue to argue that global responses to the compensation problem are rooted firmly within this paradigm, intimating that convergence of corporate governance to a liberal market based model persists.²⁰ However, there are several indicators, which will be examined herein, that the crisis has called into question various aspects of this approach. Corporate law scholarship has recently examined several aspects of the current model's weaknesses, namely the limitations of performance-based governance norms, the ineffectiveness of shareholder governance, and the inability of capital markets to signal that management's strategy is unsustainable or that the firm's existence is at risk.²¹ The impact on other stakeholders of overemphasizing the profit motive has also been a central theme. The recent revival of an alternative theory to neoclassical economics called the Double-Movement has opened inquiries in this area which shed some light on recent events such as Enron, the Financial Crisis and the growing disparity of incomes in many liberal market economies.²²

The problems identified and norms disseminated by supranational bodies such as the Financial Stability Forum (FSF), Council of European Banking Supervisors (CEBS) and various shareholder and labour organizations reveal several key differences when compared with the

¹⁹ See also, Lucian A. Bebchuck and Holger Spamann, "Regulating Bankers' Pay" (2010) 98(2) *Georg L J* 247.

²⁰ Hausmann and Bechtold-Orth, *supra* note 18.

²¹ See Leonard I. Rotman, "Re-evaluating the basis for corporate governance in the post, post-Enron era" in P.M. Vasudev and Susan Watson, *Corporate Governance after the Financial Crisis* (Northampton: Edward Elgar, 2012) 101-119; See also Millon, *supra* note 17; Jacoby, *supra* note 1, Deakin *supra* note 4.

²² Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Farrar and Rinehart: 1944); Jacoby, *supra* note 1.

post-Enron global response.²³ In the post-crisis regulatory environment the approach has shifted from improving managerial performance by encouraging greater profit-seeking and risk-taking towards ensuring that compensation incentives do not pose a risk management problem and encourage short-term gains at the expense of the corporation's long-term viability.²⁴ This post-crisis dimension of executive compensation reform and its focus on the societal effects of corporate power has unfolded at the transnational level. Having global ramifications, the crisis has spurred a need across several jurisdictions to put the brakes on a runaway train, the shareholder value norm and its relentless pursuit of shareholder wealth at all costs.

Finally, the magnitude of required change that post-crisis compensation reform has identified, namely the need to run large corporations sustainably and in the public interest, raises questions of how this can be achieved within the existing paradigm. Several regulatory themes emerge from post-crisis regulation of executive pay, indicating a shift away from the current approach towards a more stakeholder-inclusive form of governance.²⁵

SECTION C: The Promises of Agency Theory and Optimal Contracting

Before the 1990s during the period of 'managerialism' executive compensation was viewed as a potential governance problem in the firm.²⁶ The challenge was to ensure that the CEO was paid adequately for their talents but not excessively.²⁷ While this dimension of the debate still persists today, from the 1990's onwards it has been viewed more dominantly as a mechanism for controlling managerial power.²⁸ While corporate law imposes mandatory duties onto directors to manage the corporation, executive pay has developed alongside statutory norms as a self-regulatory mechanism for constraining and harnessing managerial power and talent.²⁹

²³ Guido Ferrarini and Maria Cristina Ungureanu, "Economics, Politics and International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks" (2011) 64 *Vand L R* 431.

²⁴ See Hill, *supra* note 14.

²⁵ *Ibid.*

²⁶ Charles M. Yablon, "Bonus Questions: Executive Compensation in the Era of Pay for Performance: (1999) 75 *Notre Dame LR* 271.

²⁷ *Ibid.*

²⁸ See Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay But How" (2010) 68 *Harv Bus R* 138.

²⁹ *Ibid.*

Compensation as a governance solution seeks to address managerial power in the firm. It defines managerial power narrowly in terms of agency costs, a lack of performance and risk-taking.³⁰ Preoccupied with increasing the pursuit of profit and risk-taking this approach justifies significantly higher levels of pay as long as share price is increased.³¹ It defines the principle-agent problem as the propensity of managers to withhold maximum effort, play it safe, accept higher pay for lower performance and divert the firm's resources to non-productive, self-serving ends. It attempts to solve this by replicating for the executive shareholder's incentive for greater efficiency, risk and profit-seeking, as measured by market value.³² Thus, profit maximization becomes the sole measure of good governance. This is based on the assumption that current share price is an accurate reflection of total firm value and that raising share price is the desirable outcome of properly functioning compensation incentives.³³

SECTION D: How This Governance Orthodoxy Has Now Been Challenged

The post-crisis response to compensation reform recognizes that the performance-based approach to addressing managerial power in the public corporation introduces a new set of problems into corporate governance. Executive compensation, as a solution to the agency problem has itself become a risk-management problem according to several post-crisis assessments.³⁴ There exists widespread recognition not only that the structure of pay can be flawed and fail to enhance shareholder value, but also that incentive compensation can lead executives to damage the corporation for the sake of short-term profits while harming a range of societal interests.³⁵ Corporate governance scholars have been preoccupied with the shareholder value model's outwards effects for quite some time. The CSR movement and its proponents have adeptly documented the externalities generated by profit maximization and corporate activity generally, namely the growing wealth, benefit and risk disparity between front-line workers and top management of public corporations as well as top income earners in associated finance-based

³⁰ Jensen and Murphy, *supra* note 28;

³¹ Jensen and Murphy, *Ibid.*

³² *Ibid.*

³³ *Ibid.*

³⁴ Hill, *supra* note 14.

³⁵ See Hill, *Ibid.*; Romano, *supra* note 15; Bebchuk and Spamann, *supra* note 19.

occupations.³⁶ However, the crisis represents an additional problem. The outwards negative effects of profit maximization have gone so far as to overwhelm the checks and balances of the entire governance regime, leading many to comment that the governance by performance approach is unsustainable.

SECTION E: How This Is Not Being Recognized

Amongst post-crisis assessments of compensation systems and their reform, divergent views exist on what post-crisis responses represent. The minority view holds that executive compensation has undergone a paradigm shift away from the optimal contracting model and performance based norms of conduct.³⁷ This is viewed as a partial reversal of the shift in approach that occurred in the 1990's after law and economics thinking had been firmly established in corporate law and with the advent of the Jensen and Murphy's influential piece advocating that “it’s not how much you pay but how.”³⁸

However, the majority approach attempts to explain all post-crisis responses as being consistent with optimal contracting and fails to assess whether a paradigm shift is occurring. It acknowledges that post-crisis pay reform centres on reducing excessive risk-taking and promoting a long-term sustainable approach to running the firm, yet fails to consider the magnitude of this shift and what it actually entails in the liberal-market context. These are crucial starting points for determining how to proceed with effective and sustainable reform and for assessing whether the current shareholder primacy paradigm is equipped for dealing with the changes that post-crisis compensation reform has identified. Thus, to proceed with this project, it is essential to ask the following three questions:

³⁶ See Kent Greenfield, “Saving the World With Corporate Law?” (April 3, 2007) Boston College Law School Research Paper No. 130, Available at SSRN: <http://ssrn.com/abstract=978242> or <http://dx.doi.org/10.2139/ssrn.978242>; Jacoby, *supra* note 1; See also E. Merrick Dodd Jr., *For Whom are Corporate Managers Trustees?*, (1932) 45 HARV L. REV 1145.

³⁷ See Hill, *supra* note 14.

³⁸ Jensen and Murphy, *supra* note 28.

1. What is the magnitude of the current shift in governance thinking?
2. What does the required shift entail?
3. Is the shareholder primacy paradigm equipped to accommodate this shift?

SECTION F: The Magnitude of the Current Shift

The overarching theme of controlling excessive risk-taking and advancing a longer term approach to running the firm calls forward an economic rationale on the part of directors that is inconsistent with efficiency and performance based norms of directorial conduct. Despite the attempt by mainstream scholarship to reconcile some of the differences that appear in regulatory responses between jurisdictions as fitting within the optimal contracting paradigm, these differences, it is argued, represent fundamentally divergent approaches to market governance.

While this has potentially significant implications for the convergence-divergence debate which underlies post-crisis assessments of compensation reform, from a methodological standpoint the issue is two-fold.³⁹ First, it is important to assess whether differences in regulatory approach can be reconciled with shareholder primacy or whether they diverge. The result of this determines the position we can take on whether corporate governance is continuing to converge towards a more liberal market based model or whether the approaches of certain jurisdictions are diverging.

While this in itself is instructive of shareholder primacy's efficacy in the post-crisis era, it does not demonstrate whether shareholder primacy in its own context reveals any internal consistencies with the need to constrain risk-taking and the pursuit of short-term profit. This gives rise to the second issue, whether post-crisis responses in the United States reveal at best a shift away from shareholder primacy and at least inconsistency with the need to run large public

³⁹ For a seminal contribution to the convergence-divergence debate, see Jeffrey N. Gordon and Mark J. Roe eds., *Convergence and Persistence in Corporate Governance* (Cambridge University Press: UK, 2004).

corporations sustainably and in the public interest. Here we ask a principle research question, how do post-crisis regulatory responses to compensation reform stand to impact the management orientations of large public companies in liberal and coordinated market economies? We examine the United States and Germany with respect to the regulation of executive compensation.

We find that regulatory responses in Germany reinforce stakeholder-based norms of conduct and strengthen directors' responsibilities towards protecting the corporate entity and advancing its long-term interests. The measures implemented are specifically aimed at preventing executive pay from rewarding short-term gains for shareholders or incentivizing short-term behaviour and excessive risk. The level of discretion protected under the business judgement rule is constrained through new standards for executive pay. These are implemented through increased director liability rather than increased exposure to capital market pressures.

With respect to the US we find a greater emphasis on mandatory norms of conduct centred on protecting the corporate entity. This is evident with the enhanced claw-back provision requirement under Dodd-Frank requiring directors to implement policies for detecting and recovering executive pay based not only on misrepresented earnings but also on inaccurate data in the absence of fraud.⁴⁰ Despite not requiring directors to actually make recovery, this constitutes an enhancement of directors' responsibilities to the corporate entity. Likewise, the requirement to publicly disclose the CEO to worker wage ratio under the same Act demonstrates recognition of the role that workers play in the entity's long-term sustainability.⁴¹ However, both provisions along with the others examined are reliant on the capital market's purported preference for non-financial assessment criteria and long-term sustainable corporate management as a means of enforcing these norms. We highlight the problematic aspects of this reliance.

This work concludes that German responses in several respects diverge from optimal contracting and a broader shareholder-based approach. Responses in the United States aside from demonstrating a greater emphasis on mandatory norms of conduct are to a large extent incompatible with what post-crisis compensation reform seeks to achieve, a long-term sustainable approach to running the firm in the public interest.

⁴⁰ See *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*, s 954.

⁴¹ See *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*, s 953(b).

SECTION G: What Long-Term Sustainable Governance Entails

This is the subject of a long-standing debate over how the corporation should be run, in the interests of whom and the most effective means of constraining managerial power.⁴² How managerial power is defined and how the legal-institutional nexus of corporate law is conceptualized for the purposes of reform is also at issue. At the heart of this debate are competing theories of the firm which purport to deal with managerial power in differing capacities. It is crucial to understand the consequences of either approach, the historical relevance of each, and their relationship today. To apply such a broad analysis to the executive compensation issue we need to step outside the law and economics paradigm and examine how executive pay has evolved within a historically shifting political economic and legal context.

The entity metaphor of corporate law evolved from the previous framework to deal with the problem of managerial power in the context of a neo-corporatist political-economy in the post-Great Depression era.⁴³ Referred to as the traditional legal model, this approach was the subject of intense academic debate around how directors' duties ought to be defined and which management orientation should prevail.⁴⁴ At issue were the outwards effects of managerial power on stakeholder groups and the optimal means for ensuring shareholder value.⁴⁵ The debate touched upon the appropriate consideration of stakeholder interests in order for investors to achieve sustainable returns and whether the shareholder wealth maximization norm were suitable avenues to effective governance. Directorial discretion to consider multiple interests in accordance with the best interests of the corporate entity has consequently prevailed.

The contractual metaphor evolved in the 1970's to address purported weaknesses of the legal model at the time, namely the inability of this model to address the problem of managerial slack, characterized as inefficiency and sub-optimal risk in corporate operations.⁴⁶ These factors

⁴² This goes back to the famous Berle-Dodd debate captured in three prominent Harvard Law Review articles written between 1931 and 1932. See Adolf A. Berle, "Corporate Powers As Powers In Trust" (1931) 44 *HARV L REV* 1049; E. Merrick Dodd Jr., "For Whom Are Corporate Managers Trustees?" (1932) 45 *HARV L REV* 1145; Adolf A. Berle, "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 *HARV L REV* 1365.

⁴³ See William W. Bratton and Michael L. Wachter, "Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation" (2008) 34(1) *J of Corp Law* 99.

⁴⁴ *Ibid.*

⁴⁵ See Sciulli, *supra* note 2.

⁴⁶ See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3(4) *J of Fin Econ* 305.

were attributed by economists to weak market forces which failed to adequately constrain managerial power.⁴⁷ The lack of competitiveness amongst large public corporations in the LME context was cited as the source of the rampant economic stagnation of the 1970's that ushered in an era of 'Reaganism' in the US and 'Thatcherism' in the U.K. This re-conceptualization of corporate law served as a basis for reforming corporate governance and also to explain the effects that the rapid growth of capital markets in the 1980s had on the orientations of corporate managers.⁴⁸

In sum the answer to this question of what sustainable governance entails is that a long-standing debate continues on between competing theories of the firm and the differing approaches they represent. While these approaches purport to deal with different aspects of managerial power, performance versus rent extraction, the crisis shows that the goals they seek to achieve conflict with drastic repercussions for how managerial power is constrained. This in turn highlights the need to constrain the overemphasis of the profit motive and balance profit-seeking against long-term sustainability, responsible risk-taking and stakeholder interests.

SECTION H: Prospects of the Current Approach

Here we assess whether the shareholder-primacy paradigm is equipped to accommodate the needed changes identified for post-crisis executive compensation reform to be effective. It becomes apparent that the debate over how to proceed in corporate governance towards averting another crisis and creating sustainable capitalism is divided three ways. At the heart of deciding which to accept lays a choice between competing assessments over the governance orientations that develop from director's existing level of discretion and exposure to capital market pressures.

The first approach is to increase shareholder rights and re-balance power between directors and shareholders. This entails accepting that current market forces are inadequate to achieve effective constraints on managerial power and that shareholders are better equipped at

⁴⁷ *Ibid.* See also Mark J. Roe, *Political Determinants of Corporate Governance* (OUP 2003).

⁴⁸ Roe, *Ibid.*

disciplining directors for excessive risk and unsustainable short-term profit seeking.⁴⁹

The second approach accepts that the state of management's exposure to capital market pressures and directorial discretion are not only optimal market outcomes themselves but are suitable for constraining managerial power and ensuring sustainable profit-seeking provided that the model can be internally improved.⁵⁰ This entails getting the structure of executive pay right through better norms of conduct.

Drawing on contradictions found within these former approaches, an emerging third view holds that existing market forces and the current level of directorial discretion are untenable for ensuring corporate sustainability.⁵¹ The current level of discretion protected under the business judgement rule in some respects is undesirable. Although it protects the Board's discretion to consider a multitude of stakeholder interests and rebuff investors' demands for short-term profit in favour of a longer term strategy, the Board's management orientation is equally susceptible to being influenced by demands for short-term profits and excessive risk-taking. Perverse executive compensation incentives are an outcome of these factors premised on the Board's overemphasis of the profit-motive and unfettered acceptance of performance-based norms of conduct. As long as directors have discretion to favour extreme profit-seeking as a goal on which to base compensation, unprecedented levels of pay will be justified by current share price.⁵²

We argue that this latter approach is the most accurate for approaching post-crisis reform and advance evidence to demonstrate its persuasiveness. This requires answering three questions:

- 1) What arrangements do existing market forces under the current level of directorial discretion lead to?

The answer is that current market forces in conjunction with directorial discretion

⁴⁹ This view is advanced by shareholder rights scholars. See for example Lucian A. Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118(3) *Harv L Rev* 833.

⁵⁰ This view advanced by director primacy scholars. See for example Stephen M. Bainbridge, "Director Primacy" (May 25, 2010), UCLA School of Law, Law-Econ Research Paper No. 10-06, Available at SSRN: <http://ssrn.com/abstract=1615838>.

⁵¹ This third view is what this work is advancing. There is no group of scholars that explicitly advocate for this position, however elements of it are apparent in the post crisis assessments of executive pay reform which argue that a paradigm shift is occurring away from performance based norms and market-based governance. But see James Shinn, "The Great Recession's impact on global corporate governance" in William Sun, Jim Stewart, David Pollard eds., *Corporate Governance and the Global Financial Crisis: International Perspectives* (United Kingdom: Cambridge University Press, 2011).

⁵² Post-crisis assessments of corporate governance have picked up on this point. See Millon, *supra* note 17.

produce results that are unsustainable. To support this premise we turn to scholarship on the 'Double Movement' and its application and revival by political-economists and corporate law scholars.⁵³ Evidence is presented from progressive corporate law scholarship which shows not only that the current legal-institutional framework permits such governance orientations to develop but also that current market forces are incapable of producing sustainable firm governance and a more stakeholder inclusive approach to running the firm without more.⁵⁴ The prospects of corporate law under the current business judgement rule are assessed.

2) What would increasing shareholder power result in?

The answer to this question is premised on much of the same scholarship as above, which addresses the argument to increase shareholder rights and reduce the power of the Board. The arguments against such an approach are presented and then assessed. The overarching conclusion is that shareholders are incapable of monitoring managerial power in a manner that will ensure sustainable firm development and the inclusion of stakeholder interests for both legal and structural reasons.⁵⁵

3) To what extent can directors consider the interests of other stakeholders in the face of capital market pressures?

Here the nexus between markets and management orientation is examined. The structural limitations of the existing legal-institutional framework for tolerating managerial slack have been well-documented. In the absence of adequate pressures from product and capital markets, managerial slack is said to persist, rendering firms stagnant and unable to compete.⁵⁶ In the presence of robust market pressures, firms are said to find new efficiencies to improve

⁵³ For an explanation of the Double Movement, see Polanyi, *supra* note 22. For its application to studying the crisis, see Jacoby, *supra* note 1.

⁵⁴ See Millon, *supra* note 17; Rotman, *supra* note 22; Stout, *supra* note 16.

⁵⁵ See Lynn A. Stout, "New Thinking on Shareholder Primacy" in P.M. Vasudev and Susan Watson, *Corporate Governance after the Financial Crisis* (Northampton: Edward Elgar, 2012) 24-41; Stephen M. Bainbridge, "Remarks on Say on Pay: An Unjustified Incursion on Director Authority", UCLA School of Law (2008) *Law & Economics Research Paper Series, Research Paper No. 08-0*; Alfred Rappaport, "Tens Ways to Create Shareholder Value" (2006) *Harv Bus R, On Point Article 1069*.

⁵⁶ See Roe, *supra* note 49.

competition and satisfy investor demands.⁵⁷ By exercising discretion and considering the interests of other stakeholders, managers are said to generate agency costs, signalling to investors to discipline management through their market power.⁵⁸ This includes ensuring that corporate governance mechanisms tightly bond managers' interests with shareholder wealth maximization, leaving little room for considering interests outside of this relationship.⁵⁹

Recent scholarship from Australia, a liberal market economy similar in many ways to the US, demonstrates that management is able to consider the interests of stakeholders beyond what is thought to be possible in the liberal market context.⁶⁰ Such 'high road to economic production' appears to be a feasible alternative for creating competitive firms which are sufficiently profitable to investors over time.⁶¹ This demonstrates that the optimal line between shareholder value maximization and directors' discretion to consider other interests might need to be re-assessed. However, as already mentioned, the current framework militates towards producing outcomes that are fixated on short-term returns that are unsustainable. Thus, to affect such a change, stakeholder based norms are needed along with a means for their enforcement.

SECTION I: Thesis

After assessing the magnitude of the changes that post crisis compensation reform is calling for and what these changes actually entail, we can address the ultimate question this work seeks to address, whether the shareholder primacy model is equipped to accommodate this change or whether and to what extent directors should be required to consider the long-term interests of the firm and its stakeholder when setting executive pay? This work argues that the attempt of mainstream corporate legal scholarship to conceptualize and analyze the changes that have occurred with respect to executive compensation and its ongoing reform and regulation from the dominant paradigm is problematic because it ultimately reveals several inadequacies and inconsistencies in this approach and is an inaccurate rendition of the significance and

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ Richard Mitchell, Anthony O'Donnell, Shelley Marshall, Ian Ramsay and Meredith Jones, *Law, Corporate Governance and Partnerships at Work: A Study of Australian Regulatory Style and Business Practice* (Ashgate Publishing 2011).

⁶¹ *Ibid.*

magnitude of these changes and what they represent for corporate governance. This in turn has practical consequences because it informs the types of norms that will underpin corporate governance arrangements moving forward from the crisis which are supposed to prevent a similar economic meltdown and its widespread societal repercussions.

SECTION J: Can the Current Approach to Compensation Reform Support Sustainable Governance?

To apply the broader question of whether shareholder primacy is suitable for attaining sustainable governance, specifically to executive pay, we must ask the following two questions:

1. Should agency costs be predominantly defined as a lack of performance and does attempting to constrain managerial power through performance-based norms of conduct exacerbate its outwards effects?
2. Can excessive risk-taking and short-term profit-seeking be effectively constrained by adjusting the structure of executive compensation to better align shareholder and manager interests without changing the existing level of directors' discretion and exposure to capital market pressures?

PART I- STEPPING OUTSIDE AGENCY THEORY

CHAPTER THREE:

Disentangling Narratives on Executive Pay

Several narratives can be identified in the literature which often overlap but are conflated in assessments of the executive pay problem. Disentangling the debate on executive pay in this manner allows us to identify which interests are at play, the underlying tensions between them and how the debate has evolved historically. This serves to further an understanding of the debate's basic concepts and to orient our analysis outside the law and economics paradigm. The pay for performance perspective is but one paradigm for conceptualizing the problem.

SECTION A: Excessiveness as Societal Fairness

This narrative represents a debate over the distribution of the firm's value added amongst economic actors. It raises the question, "how much do corporate executives really contribute to the firm's success to deserve a disproportionate share of its wealth?" and juxtaposes the interests of the firm's executives against the well-being of its employees. More broadly, it represents a conflict between the wealth extracting function of the corporation and society's interests in fairer wealth distribution.

From this perspective, critics call into question the size of the executive's total remuneration and the issuance of stock option mega grants by Boards of Directors on the basis that production is a team effort and that excessive pay harms society by contributing to inequality.⁶² This argument was dominant in the period leading up to the 1990's when labor unions and public interest groups in the U.S. began to vociferously challenge the level of compensation being awarded to those at the helm of large U.S. publicly traded corporations.⁶³

⁶² Linda J. Barris, "The Over-Compensation Problem: A Collective Approach to Controlling Executive Pay" (1992) 68 *Ind L J* 59; Mark A. Salky, "The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either or Neither Necessary?" (1994-95) 49 *U of Miami L Rev* 795.

⁶³ Barris, *Ibid.*

During this period which spanned the 1980's executive compensation on average rose a staggering 212% which stood in sharp contrast to the preceding decade in which executive compensation on average rose only 30% between the years 1971 and 1981.⁶⁴

The 1990's ushered in a period of economic recession which markedly impacted the performance of U.S. public firms who were forced to shed hundreds of thousands of jobs to maintain profitability. While factory workers statistically received on average a 2.8% increase in wages for that year, inflation was pegged at 6.1%.⁶⁵ Corporate profits declined by 7% during the same period while the average total compensation for the top executive continued to rise. This line of the excessiveness critique highlights the juxtaposition that emerges in this period between the interests of workers, executives and shareholders.⁶⁶

This conflict is further exacerbated by executives receiving even higher levels of pay than the previous decade while invoking severe cost cutting measures in the recessionary economy that impact front-line workers. This rapid expansion in overall executive compensation is driven by the proliferation of stock option mega-grants justified by compensation consultants and Boards of Directors as paying for performance.⁶⁷ While, corporate profits on average are down, workers bear a disproportionate share of these economic losses, while executives are rewarded for making difficult decisions aimed at maintaining profitability for shareholders.⁶⁸

The excessiveness problem highlights how a conflict over fairness between managers and workers maps over a more fundamental debate on corporate purpose. The question of whether a particular level of pay is merited can be answered in reference to multiple iterations of performance goals corresponding to different visions of corporate purpose. One such possibility is to view the executive's compensation as being merited because it rewards ruthlessly efficient and unmitigated exploitation of the resources necessary for the creation of wealth for investors without any regard for the societal effects of this strategy, the so-called shareholder value norm

⁶⁴ Barris, *Ibid*; See also Yablon, *supra* note 26.

⁶⁵ Barris, *Ibid*.

⁶⁶ *Ibid*.

⁶⁷ Barris, *Ibid*. See also Yablon, *supra* note 26.

⁶⁸ *Ibid*.

as some have criticized it.⁶⁹ Another such possibility is to view the executive's compensation as being merited because it rewards the executive for being a 'good corporate citizen' and for implementing 'partnerships-at-work' style employee management systems where employees fare better overall in the enterprise.⁷⁰

SECTION B: Excessiveness as Corporate Waste

A second branch of the "excessiveness" narrative is found within corporate governance discourse. Directors entrusted to promote the corporation's well-being and safeguard its assets are influenced by managers to approve compensation that grossly exceeds the reasonable and fair value of what the executive is worth. Excessive pay damages the corporation because it generates waste and undue costs which affect its competitiveness.⁷¹ It rewards executives for under-performing and encourages sub-standard effort which affects value over the long-run.⁷²

This narrative of the over-compensation problem is two-fold. On the one hand it represents a critique of managerial power in the firm, the problem of self-interested behavior and a lack of directorial oversight. It focuses on protecting the corporation's assets from being appropriated by the firm's managers. This problem invokes the basic function served by fiduciary duties, to provide a mechanism for the stockholders to protect their investment from the most basic forms of malfeasance and to act as guardians of the corporation's property.

Under statute, shareholders have the right to bring suit on behalf of the firm to discipline managers and recover any losses for the corporation.⁷³ In earlier suits by shareholders alleging

⁶⁹ See Nikos Passas, "Lawful but awful: 'Legal Corporate Crimes'" (2005) *34 J of Socio Economics* 771; See also, Stout, *supra* note 16.

⁷⁰ These opposing views of corporate purpose have been captured in the 'high road' versus 'low road' to economic success debate that appears in a recent study of comparative corporate governance. See Mitchell et al., *supra* note 62. (This literature explores the range of possibilities available for corporations to structure their relationships, govern their activities, and define their corporate objectives in the context of differing constellations of institutional factors.)

⁷¹ See Barris, *supra* note 62 at 66 (noting that large compensation packages strip corporations of assets, devalue the stock, and cheat shareholders out of significant sums of money).

⁷² John Murrey III, "Excessive Compensation in Publicly Held Corporations: Is the Doctrine of Waste Still Applicable?" (2006) *108 W Virginia L R* 2; Steven S. Caywood, "Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation" (2010) *109 Michigan L R* 111.

⁷³ For an explanation of the derivative action see Stanley M. Beck, "The Shareholders' Derivative Action" (1974) *52 CBR* 159.

that the executive's compensation was unreasonable, courts would distinguish between interested and disinterested Boards.⁷⁴ If a substantial portion of the Board had an interest in the compensation being awarded, courts would not presume reasonableness or good faith on the Board's part and would shift the burden onto directors to prove that the compensation was reasonable.⁷⁵

If the Board for the most part was made up of disinterested directors and no evidence existed that it failed to inform itself of all reasonably available material concerning the compensation then courts would presume that directors acted in good faith in a manner that they believed to be in the best interests of the corporation, extending the protection of the business judgment rule from liability for unreasonable or poor decisions.⁷⁶ Being concerned only with the quintessential problem of self-interested behavior, courts were careful not to heighten the ability of the stockholders to readily allege fraud and excessively scrutinize expenditures.⁷⁷

Realizing the problem with appropriation and opportunistic behavior of this type in the period following the Great Depression, legislators enacted requirements for public corporations to disclose compensation details. A variation of this problem still persists (and is arguably exacerbated) with incentive compensation and stock option plans. Having been well documented since at least the early 1990's executives have been known to manipulate earnings and engage in fraudulent misrepresentation of financial information to enhance the value of their options or hide internal problems that might lower their value.⁷⁸

Another related phenomenon documented since the 1990's is "stealth compensation" which amounts to extractions of the corporation's wealth in the form of high pay.⁷⁹ By failing to declare or account for the true costs of stock option grants to the corporation until several years down the road when these costs have multiplied, shareholders are in effect misled over the actual sums of money being paid to the executive and its impact on future share value when the options

⁷⁴ Murrey, *supra* note 72.

⁷⁵ *Ibid.*

⁷⁶ *Ibid.* (noting that "the rule provides that the quality of the decision is not determinative of liability, only the process utilized in reaching the decision"). This article is one of few comprehensive reviews of the doctrine of waste in several years.

⁷⁷ Murrey, *Ibid.* (noting the economic impracticality of allowing shareholders to challenge managers on every decision they might disagree with). From these early rulings emerged the practice of independent compensation committees as a way of staving off judicial suspicions of self-interestedness.

⁷⁸ For a discussion of this see Barris, *supra* note 62. This was also a key aspect of the Enron scandal.

⁷⁹ For a detailed discussion of stealth compensation as a form of wealth extraction see Graef S. Crystal, "Stealth Compensation" (18 February 1992) *Fin. World*.

vest. Both the former and the latter practice has since been a target of legislation in the post Enron era.⁸⁰

On the other hand, recognizing the vulnerable position of stockholders, courts in some cases began to recognize that scenarios existed where directors even when acting in good faith failed to ensure that the compensation awarded was reasonable.⁸¹ The earliest of such cases was *Rogers v. Hill*⁸² in which a group of minority shareholders through a derivative suit challenged the level of pay awarded by American Tobacco's Board to its CEO George Washington Hill. Despite being approved by a majority of the stockholders the Supreme Court recognized that the sheer amount of the compensation awarded could amount "to a spoliation and waste of corporate property" for which the corporation receives no equivalent benefit even if directors or a majority of shareholders approve the payments in good faith.⁸³

The requirement created by the doctrine of corporate waste, at least in the earlier cases, goes beyond the role that fiduciaries play in stemming self-interested behavior. By prohibiting directors from wasting corporate assets, it seeks to protect the vulnerable position of the shareholder. Essentially the doctrine creates a positive, albeit limited, requirement for performance when dispensing with the corporation's assets. Despite assertions the doctrine fails to go far enough,⁸⁴ the basic function of guarding against mismanagement without juxtaposing the interests of shareholders against the corporation is fulfilled.

The doctrine of waste represents a set of trade-offs between the rights and interests of shareholders and directors and between different groups of investors. By sanctioning poor judgment with how assets are deployed, the doctrine gives shareholders limited rights to protect their vulnerable position against more than just fraud, to ensure the corporation's economic survival. Through procedural burdens and evidentiary thresholds, courts have drawn a line between excessive and meritorious litigation, both impediments to corporate organization.⁸⁵ Courts have been careful to restrain shareholder power through a reluctance to substitute their

⁸⁰ Jesse M. Fried and Nitzan Shilon, "The Dodd-Frank Claw-Back and the Problem of Excess Pay" *The Corporate Board* (Jan-Feb 2012), Online: Harvard Law, <<http://www.law.harvard.edu/faculty/jfried/1201FriedShilon.pdf>>; See also Stephen M. Bainbridge, "Dodd-Frank: Quack Federal Corporate Governance Round II" (2010-2011) *95 Minn L Rev* 1779 at 1806.

⁸¹ Murrey, *supra* note 72. Note that Murrey performs a detailed review of the doctrine's historical development.

⁸² *Rogers v. Hill*, 289 U.S. 582, 53 S. Ct. 731 (1933).

⁸³ *Ibid.*

⁸⁴ The doctrine is criticized for having a high threshold for being granted an evidentiary hearing on allegations of waste, thus suppressing meritorious litigation. See Murrey, *supra* note 72 at 7; See also Caywood, *supra* note 72.

⁸⁵ *Ibid.*

judgment for what ought to have been reasonable in hindsight.⁸⁶ Directors are allowed to be wrong as long as they acted informed and diligently.⁸⁷

Caution to not discourage risk-taking is balanced against the reality that shareholders are inherently risk bearers, can mitigate this risk and can benefit greatly if the risk pays off. The doctrine therefore sets a minimum standard for the benefit that directors must endeavor to obtain, but stops short of requiring that benefit to actually materialize. For instance, high compensation levels can be approved to attain top talent and superior performance, yet there is no recourse if the performance fails to materialize.

In general, corporate law prevents shareholders from dictating that the profit motive must be emphasized. It affords discretion to balance competing interests in a manner directors believe in good faith benefits the corporation. The courts have been careful not to enable shareholders to place their interests ahead of the corporation's and limit their intervention to enforcing norms of trust, not efficiency.⁸⁸ However, the standard is broad enough to allow managers to favor strategies that are closely aligned with their own interests in extracting high compensation and expanding the firm to increase their power.⁸⁹

SECTION C: Excessiveness as a Lack of Performance

This narrative problematizes excessiveness in relation to performance only and is not necessarily based on the overall size of the compensation being awarded. Accordingly, the largest detriment to the corporation of overindulging its top executive is the cost of lost economic benefit. Paying excessively in relation to performance means for the same amount of compensation directors could have obtained better results, which translates into better returns for the stockholders who invest on unspecified terms. Yet for several reasons directors either fail to obtain value for the firm when hiring the executive or fail to discipline the executive for poor

⁸⁶ *Ibid.*

⁸⁷ *Ibid.*

⁸⁸ *Ibid.*

⁸⁹ Caywood, *supra* note 72.

performance.⁹⁰

Although not clarified in the literature, excessiveness as gauged by performance presumably exists on a spectrum at which one end the executive exerts a satisfactory effort in running the company efficiently and creating growth while at the other they drive growth aggressively to secure the maximum rate of return for shareholders. There are short-term versus long-term trade-offs involved in either of these approaches and they impact the interests of the corporation's constituents in various ways, depending on how performance is measured and defined.

Although intertwined with the discourse over improving incentives for performance, this is not a critique that pay incentives fail to properly motivate but that they fail to curb overindulgence by rewarding sub-standard performance.⁹¹ This viewpoint criticizes the size of executive compensation and views mechanisms such as incentive compensation as failing to ensure that executives are being rewarded for actual performance, regardless of how that performance is defined. Thus, stock option plans fail to reward the executive for actual contributions and hard work because they tie overall pay to the market which rises and falls, allowing the executive to profit from lucky circumstances and crafty tactics.⁹²

This particular problem reflects the propensity of managers to exploit weaknesses in their compensation schemes and to extract rents from the firm. This is related to but differs from managerial slack. It also serves to highlight the limitations of allowing capital markets to

⁹⁰ This is attributable to the quintessential problem of self-interested behavior by managers and the influence they have on the Board which approves higher than usual compensation levels and fails to reprimand the executive or reduce pay when performance begins to stagnate. It has been noted that Boards are often nominated by the CEO and that strong social ties exist between directors and executives creating a counter-incentive for directors to hold unreasonable levels of compensation in check, bargain for better value, or adjust the remuneration when the state of the company deteriorates. See Lucian A. Bebchuk, Jesse M. Fried and David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (June 2002), 69 *University of Chicago L R* 751; see also Randall S. Thomas, "Explaining the International CEO Pay Gap: Board Capture or Market Driven? *Vanderbilt Law and Economics Research Paper No. 02-19* (14 November 2002), Online: SSRN, <<http://ssrn.com/abstract=353561> or <http://dx.doi.org/10.2139/ssrn.353561>>.

⁹¹ Barris, *supra* note 62 at 65 (noting that "if executives are performing so well [to justify current levels of high pay] why are corporate profits stagnating or declining? Average corporate profits dropped 7% in 1990 while average CEO pay rose 7%, strong evidence that executives are being rewarded in spite of performance, not because of performance.").

⁹² See Barris, *supra* note 62 at 12.

determine what the executive is worth.⁹³ Finally it speaks to the reluctance and inability of directors to ensure that pay is in line with performance by making better bargains with executives and ensuring that pay remains proportionate to performance over time.

SECTION D: Performance Perspective

The “performance” perspective builds on the latter by extending the problem to a lack shareholder wealth maximization. The excessive pay aspect is downplayed and superseded by the need to ensure executives are performing at the highest level possible. This approach places no maximum value on compensation and views high pay as a necessary tool for creating high levels of performance by capital market value. The focus is on ensuring compensation is tightly linked to performance as opposed to reducing its size.⁹⁴

In response to the perceived inability of the corporate waste doctrine to curb excessive pay and the inadequacies of corporate law to solve the managerial performance issue,⁹⁵ the over compensation problem was re-conceptualized from being a corporate governance problem to a corporate governance tool.⁹⁶ Unlike positing that performance exists on a discretionary spectrum, this view posits management’s sole function is to maximize shareholder wealth. This entails redefining corporate value metrics and a narrow conceptualization of managerial power in the firm.⁹⁷

I. Optimal Contracting Model

The use of incentive compensation is supported by optimal contracting theory. This

⁹³ Barris, *Ibid.* (noting that many compensation packages are constructed so that the executive profits in good times and is protected in bad).

⁹⁴ Jensen and Murphy *supra* note 28; Bebchuk and Fried, *Pay Without Performance: The Unfilled Promise of Executive Compensation* (First Harvard University Press: USA, 2004); Michael S. Weisbach, “Optimal Executive Compensation vs. Managerial Power: A Review of Lucian Bebchuk and Jesse Fried’s “Pay Without Performance: The Unfilled Promise of Executive Compensation” National Bureau of Economic Research, Working Paper 12798 (2006), Online: NBER, <<http://ssrn.com/abstract=955231>>.

⁹⁵ See Theodor Baums and Kenneth E. Scott, “Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany” (2005) *ECGI, Law Working Paper No. 17/2003*.

⁹⁶ Hill, *supra* note 14.

⁹⁷ For an explanation and analysis of this variation of the nexus of contracts metaphor and its implication for corporate governance, see William W. Bratton, “The “Nexus of Contracts” Corporation: A Critical Appraisal” (1989) 47 *Corn L Rev* 407.

model defines managerial power as agency costs, which are created when managers deviate from the shareholder value norm.⁹⁸ Agency costs include the propensity of managers to withhold maximum effort, divert corporate strategy in non-efficient ways to further their own ends, and to take sub-optimal risks by playing it safe.⁹⁹ The aim of executive pay is to replicate shareholder incentives to take greater risks, maximize returns for shareholders and to refrain from considering non-shareholder interests.¹⁰⁰ This can be summarized as follows:

“At its most basic level, the granting of incentives is based upon the “greed” principle: An executive will make decisions which he believes will increase the value of his corporation’s stock, which in turn will increase his personal wealth. While the executive is busy assuring his personal gain, he assures gain for all.”¹⁰¹

This narrow definition of managerial power minimizes the problematic perceptions around wealth extraction and corporate waste. If shareholders are experiencing high returns, significantly higher levels of pay are tolerated.¹⁰² Excessive pay is relevant only in relation to performance as an indicator that incentive contracts are not functioning well enough.¹⁰³ High levels of pay are seen as being necessary for creating incentives that work.¹⁰⁴ The biggest cost of excessive and improperly structured compensation is lost performance.¹⁰⁵

Optimal incentive contracts are assumed to arise in the existing framework of corporate law if two essential conditions are met.¹⁰⁶ The first is that directors understand their duties are to maximize shareholder wealth and act accordingly.¹⁰⁷ The second is for capital markets to work

⁹⁸ This is based on the shareholder primacy theory’s definition of the agency problem in the firm, see Jensen and Meckling, *supra* note 28; see also Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (First Harvard University Press: USA, 2006).

⁹⁹ Jensen and Murphy, *supra* note 28; Joseph G. Haubrich, “Risk Aversion, Performance Pay, and the Principal-Agent Problem” (1994) *102 J Pol Econ* 258. For an explanation of empire building see Bebchuk and Fried, *supra* note 94.

¹⁰⁰ Haubrich, *supra* note 99.

¹⁰¹ Barris, *supra* note 62 at 67.

¹⁰² Jensen and Murphy, *supra* note 28.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ Bebchuk and Fried, *supra* note 94.

¹⁰⁶ This is a summary of the literature on optimal contracting and not presented as such by these authors.

¹⁰⁷ This entails that directors bargain at arm’s length with directors over compensation, remain disinterested in the process, limit the extent to which they consider other interests when setting pay, avail themselves of all material information and best practices, and focus more generally on conducting a fair process as opposed to considering the effects of the incentive plan. To meet these conditions the Board typically delegates compensation to a separate committee.

efficiently and convey sufficient information about the firm to shareholders.¹⁰⁸ Provided that directors are professional, independent and disinterested they will heed to the demands of capital markets and bargain for compensation that is optimal in structure and size. Likewise if shareholders are privy to accurate and timely disclosure on earnings and other relevant data, they can gauge how agency costs are being managed.¹⁰⁹

This model relies on the efficient markets hypothesis (“EMH”) which posits that capital markets are efficient at pricing firms accurately and reflect available public data.¹¹⁰ Moreover, the price changes instantly to reflect newly available public information such as quarterly earnings.¹¹¹ Thus, current market price reflects shareholders’ future expectations of the firm’s performance.¹¹² Many have argued that capital markets are poor at reflecting hidden financial information about the firm, especially when the costs of short-term strategies materialize much later.¹¹³

In 1990’s when high executive compensation became a popular solution to controlling agency costs as opposed to a product of managerial power itself, the principle problem identified was that compensation incentives were not high-powered enough.¹¹⁴ This criticism advanced by Jensen and Murphy and others was levelled at the design of executive compensation and posited that if directors were truly acting in shareholders’ interests they would do away with bureaucratic compensation schemes.¹¹⁵ The problem defined was not a failure of the market to place

¹⁰⁸ This is achieved through mandatory disclosure rules and filing requirements imposed by most capital market regulators. They serve the purpose of conveying information to shareholders to protect them both from the fraudulent and self-interested behavior of corporate managers including the propensity of some managers to appropriate wealth by misstating earnings and to inform shareholders of the company’s performance so that capital markets can accurately price the firm’s value.

¹⁰⁹ Ronald J. Gilson, “Corporate Governance and Economic Efficiency: When Do Institutions Matter?” (1996) 74 *Wash U LQ* 327; Jeffrey N. Gordon, “What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections” (2002) 69(3) *U Chicago L R* 1233; Anne T. Coughlan and Ronald M. Schmidt, “Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation” (1985) 7(1) *J Acct & Econ* 43.

¹¹⁰ For a detailed discussion of this theory see, Eugene F. Fama, “Efficient Capital Markets: II” (1991) 46 (5) *J of Fin* 157; See also Eugene F. Fama, “The Behavior of Stock Market Prices” (1965) 38(1) *J of Bus* 34.

¹¹¹ *Ibid.*

¹¹² Stout, *supra* note 57. Also noting that the financial institutions that collapsed in the 2007/2008 crisis and the firms in the 2001 scandal, namely Enron, exhibited strong share price performance up until accurate information on the firm became known to the public. Enron for instance claimed \$101 Billion in revenues in the year preceding the scandal and was voted “America’s Most Innovative Company” yet declared bankruptcy the following year due to a massive accounting fraud. Likewise, the market value of Citigroup, AIG and Morgan Stanley before the financial crisis was at a record high and plummeted in the subsequent year, yet to recover.

¹¹³ See Henry G. Manne, “Mergers and the Market for Corporate Control” (1965) 73 *J of Pol Econ* 110.

¹¹⁴ Jensen and Murphy, *supra* note 28.

¹¹⁵ *Ibid.*

sufficient pressure on directors, as the clamour by shareholders over excessive pay was quite loud. It was that directors needed to develop better practices as opposed to giving into pressures from public interest groups to reduce the size of pay.¹¹⁶

II. Managerial Power Approach

Another theory from within this paradigm is the managerial power approach. Like contemporary proponents of optimal contracting, these scholars attempt to explain why incentives fail to create performance in the long-run. While accepting the validity of the optimal model, this approach explains why optimal contracting fails to occur and proposes a solution for ensuring that Boards develop optimal compensation contracts.¹¹⁷

The managerial power approach challenges whether markets within the existing framework of corporate law exert adequate pressure onto directors. While they acknowledge shareholders exert pressure on directors to set pay in their interests they posit that managers exert significant counter-pressure that undermines the sensitivity of pay to performance and interferes with the design of compensation as a form of rent extraction.¹¹⁸ The implications of this are significant both inside and outside the performance paradigm because it highlights the limitations of what compensation incentives can achieve. It demonstrates that incentive compensation is not a comprehensive solution for all manifestations of managerial power. While incentives can motivate managers to pursue value maximization, they cannot prevent managers from undoing their own restraints.

The managerial power approach posits the design of executive pay not only as an instrument for addressing the agency problem but as part of the agency problem itself.¹¹⁹ In fact, two agency problems exist. The first, between executives and the Board, while the second, between the Board and shareholders. Ineffective arrangements are negotiated when the Board succumbs to managerial influence through non-arm's length bargaining. These include higher than optimal pay amounts, golden parachutes, executive loans and stealth compensation. This has

¹¹⁶ *Ibid.*

¹¹⁷ Bebchuk and Fried, *supra* note 94; see also Lucian A. Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem" (2003) 17 *J of Econ Perspectives* 71.

¹¹⁸ Bebchuk and Fried, *supra* note 94.

¹¹⁹ Bebchuk and Fried, *supra* note 117.

two consequences. One is that managers extract a rent from the firm by receiving higher levels of pay than those obtainable at arm's length. The other is that performance is decoupled from pay resulting in forgone earnings and firm value which are substantial in size.

A key distinction is made between differing manifestations of managerial power and how they should be addressed. Managerial slack, suboptimal risk-taking and empire building is purportedly addressed by properly functioning compensation incentives. The effective control of rent extraction, executive greed and the propensity of managers to undo their own restraints depend on the Board's willingness and ability to resist such pressures.¹²⁰ The Board's propensity to negotiate pay that is highly sensitive to performance and to keep rent extraction in check is impacted by the extent of managerial influence on the Board, the quality of directors and their practices, and shareholders' ability to effectively discipline the Board. Without adequate shareholder pressure on directors to resist managerial power, the Board is unable to negotiate optimal performance incentives.¹²¹

Section E: Stakeholder Perspective

The stakeholder perspective fits neither into the excessiveness nor performance based category of critique but instead looks at how the size and structure of compensation plans impact the corporation as an entity and its various constituents. Focusing more on the net benefits of compensation schemes and their outcomes, one sub-set of this narrative in particular problematizes the size of high-powered incentive schemes arguing that they undermine worker morale and productivity which in turn impacts the firm quite markedly in the long run.¹²² These effects arguably outweigh the immediate benefits that high-powered compensation incentives might have on the firm's performance and call on directors to carefully weigh the costs and benefits of compensation arrangements in accordance with their duties to the corporation.¹²³

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² See Randall S. Thomas, "Should Directors Reduce Executive Pay?" (2002) 54 *Hast L J* 2.

¹²³ Professor Thomas suggests that "directors' duty of care obligates them to be reasonably informed about the value of these plans as that constitutes material information about their firm." See Thomas, *Ibid.*

Unlike the optimal contracting model which posits directors' sole focus as creating powerful incentives for the CEO to maximize shareholder value through maximizing their own wealth, this perspective invokes directors' discretion to determine whether the size of executive pay should be limited for the best interests of the corporate entity. This is not necessarily for the purposes of controlling corporate waste but to account for how incentive compensation, or more generally the side effects of aligning shareholder and executive interests more closely, impacts other corporate constituents and how this in turn impacts the firm's long-term performance.¹²⁴

In response to growing levels of CEO pay in the post-Enron period and the flurry of proxy activity by activist shareholders claiming that high levels of CEO to worker wage disparity are harmful to society, Professor Randall Thomas poses the question, should corporate directors respond to these claims and do such executive pay practices harm their firms and implicate Boards' fiduciary duties? He argues that:

“Wide gaps between the top and bottom of the pay scale can, in certain circumstances, directly and adversely affect firm value, that corporate boards should be informed about these effects and in many cases they should reduce internal pay differentials to address them.”¹²⁵

Professor Thomas canvasses numerous empirical studies that link wide disparities between top management and front-line worker pay to poor long-term performance. As these disparities grow, workers begin to feel resentment towards management and their own performance, productivity and commitment towards that firm begin to diminish. Thomas cites that stock option mega grants, defined as grants of over \$10 Million, are the primary contributors to such disparities.

These effects are further exacerbated in a recessionary economy when CEO's begin to lay-off workers to maintain profitability. Often, massive corporate lay-offs will cause temporary gains in stock price, triggering the cashing-in of CEO stock options. Executives, knowing that the future of their company is uncertain, utilize their inside knowledge to cash in their options at

¹²⁴ See proposal by AFL-CIO to disclose internal wage disparity to shareholders. AFL-CIO “Conference Addresses CEO to Worker Pay Disparity” *AFL-CIO* (2011), Online: <<http://www.aflcio.org/Blog/Corporate-Greed/Conference-Addresses-CEO-to-Worker-Pay-Disparity>> (noting that, “for investors, the CEO-to-typical employee pay disparity ratio is an important gauge of the effectiveness of the board. The pay disparity ratio is also important for investors in assessing the efficiency of a company because a steep gap affects employee productivity, morale and turnover”). See also, Randall S. Thomas & Kenneth J. Martin, “The Determinants of Shareholder Voting on Stock Option Plans” (2000) 35 *Wake Forest L R* 31 (noting that shareholders have noticed and reacted to the real cost of stock option mega grants).

¹²⁵ Thomas, *supra* note 122.

the opportune time. Thomas argues that “directors’ duty of care obligates them to be informed about the value of these plans as that constitutes material information about their firm.”

At its core this perspective calls on directors to weigh the benefits and costs to shareholders of short-term versus long-term modes of running the firm and ties the interests of stakeholders into the latter as being necessary of consideration for achieving this end. Given that the desired aim of incentive compensation is to effect sustained shareholder value, this argument questions whether key inherent features of the optimal contracting model such as the need for extraordinary levels of compensation and a sole focus on shareholder returns can actually achieve the task of creating value over the long-run. In doing so, it makes an assertion that the firm should be run with the interests of stakeholders in mind and that mandatory norms in corporate law should play a more central role in the setting of executive compensation.¹²⁶

The same critical lens can be applied to analyzing some of the other effects that compensation incentives might have on managerial behavior such as increased risk-taking and aggressive pursuit of short-term returns and the consequences this has for stakeholders in the context of corporate organization. From this perspective the issue of perverse incentives can be problematized not as a misalignment between shareholder and executive interests, but as an inherent feature of incentive compensation and the optimal contracting model.

The phenomenon of managers extensively pursuing short-term goals instead of positioning the company for the future can be construed as an effect of using incentive compensation to improve a firm’s market value, of rendering shareholders more responsive to the short-term demands of shareholders and as a by-product of pursuing the shareholder value norm without considering the impact of its externalities. In effect pursuing higher levels of profitability more aggressively through increased risk-taking has its own set of consequences for the firm which directors from this standpoint should be poised to assess and differs from the dynamic that arises when a more long-term approach to managing the firm is pursued.

¹²⁶ This refers to the directors’ duty to act in the best interests of the corporate entity as an ongoing concern and not to jeopardize the entity’s well-being for the sake of short-term shareholder wealth. The basic concept is that economic benefits should flow from the entity if directors act in its best interests, which necessarily entails profit maximization, as opposed to seeking profit maximization as an end in itself.

Unlike the performance perspective from which the goal of incentive compensation is to limit the extent to which managers might consider other interests, which is defined as an agency cost¹²⁷ or as political interference in the effectiveness of the compensation incentive,¹²⁸ this approach allows us to examine the externalities of emphasizing the profit motive. At the far end of the spectrum, these externalities have the potential to bear systemic risk by threatening the firm. By utilizing a stakeholder perspective to problematize incentive compensation and optimal contracting, several juxtapositions and trade-offs become evident. These can be analyzed across three key areas: 1) short-term versus long-term performance 2) excessive versus inadequate risk-taking and 3) wealth appropriation versus inadequate performance.

I. Short-term versus Long-term Performance

Several trade-offs exist between pursuing short-term versus long-term performance and incentive compensation being tied directly to the capital market, renders executives sensitive to the short-term demands of shareholders.¹²⁹ In simple terms, incentive compensation is designed to induce managers to pursue more profit without differentiating necessarily between short and long term performance.¹³⁰ This raises an important question, what can corporate executives do to raise share price and what are the limits on how high profits can be raised?

II. Excessive Risk versus Inadequate Risk

Given that the purpose of incentive compensation is aimed at increasing risk-taking in the firm and not at curbing it, which could be perceived as an agency cost, it can be expected that this is exactly what executives would do, especially if they are rewarded for success and immunized from the costs of failure which are distributed to other constituents.¹³¹ In fact, this is

¹²⁷ Professor Roe equates social democracy which entails amongst other things the fairer distribution of wealth and risk in civil society to agency costs. Roe, *supra* note 47.

¹²⁸ Jensen and Murphy posit that the reason why compensation was excessive is because incentives for managerial performance were not high powered enough due to outside influence from the public and labor unions.

¹²⁹ As the company's market value fluctuates, so does the value of the executive's compensation package. Exercising options when share price is low could cost the executive as opposed to exercising options when share price is high.

¹³⁰ Incentive compensation puts no ceiling on how high profits can soar. These limits are defined by the efficiency, organization and capacity of individual firms.

¹³¹ It has been noted that incentive compensation and stock option grants reward executives for upside risk which are gains only in share price but not for downside risk which are losses in firm value beyond the original value of the options. It has also been noted that Boards will often re-price the original value of the CEO's options if they go underwater. See Yablon, *supra* note 26.

arguably what some shareholders seek, high gains for high risk-taking without being exposed to significant costs.¹³² This is justified under the economic theory of the firm because other constituents are presumed to take these externalities into consideration when they bargain with the firm.¹³³

However, it has been argued that this scenario in some cases poses a moral hazard in which shareholders and the CEO can afford to take greater risks because the consequences of failure are spread to several other parties who are not direct beneficiaries of the risk.¹³⁴ For shareholders this is not usually a problem until the risk becomes so great that it results in firm failure, undermining confidence in markets. On the flip-side, inadequate risk-taking leads to firms that cannot compete effectively in the global market economy because managers fail to innovate, find efficiencies, and instead extract high levels of pay for sub-standard performance.¹³⁵ In economic terms, risk aversion can lead to sub-optimal allocation of resources¹³⁶ which is damaging to shareholders who invest for high rates of return.¹³⁷

III. Wealth Appropriation versus Inadequate Performance

The third key area where the inherent trade-offs of incentive compensation and the optimal contracting model can be analyzed is the constraining of managerial power. At one end

¹³² Stout, *supra* note 57.

¹³³ Easterbrook and Fischel, *supra* note 98; Ronald H. Coase, “[The Problem of Social Cost](#)” (1960) 3(1) *J of L & Econ*.

¹³⁴ For a recent discussion of the moral hazard that exists for shareholders of financial institutions see Bebchuk and Spamann, *supra* note 19 (noting that “the interests of common shareholders could be served by more risk-taking than is socially desirable...accordingly, while such measures could eliminate risk-taking that is excessive even from shareholders’ point of view, they cannot be expected to prevent risk-taking that serves shareholders but is socially excessive”).

¹³⁵ Wulf A. Kaal, Richard W. Painter, “Initial Reflection on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States” (2010) 40 *Seton Hall L Rev* 1040 (noting that “Risk is not inherently bad, and indeed, the economy thrives on some types of risk... Achieving an appropriate balance between risks that are informed and reasonable on the one hand and risks that are unreasonable or uninformed on the other is a challenge in managing a business enterprise, particularly a financial institution... Corporate directors are charged with numerous tasks, and the emphasis in the United States, and increasingly in other countries is on maximizing shareholder wealth. In order to do their jobs, managers often must take reasonable risks while avoiding excessive risk.”)

¹³⁶ See Kaal and Painter, *supra* note 135, at 1041 citing Markus Ruffner, “Sorgfalts- und Treuepflichten und die Versicherbarkeit von Haftungsrisiken in Publikumsgesellschaften - eine ökonomische Analyse” (2000) 119 *ZEITSCHRIFT FÜR SCHWEIZERISCHE RECHT [ZSR] [JOURNAL OF Swiss Law]* 195 at 213 (Ger.).

¹³⁷ See Kaal and Painter, *supra* note 135 at 1041 citing excerpt from *Gagliardi v. TriFoods Int'l*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (“Shareholders do not want (or should not rationally want) directors to be risk averse...shareholders’ investment interest, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm’s cost of capital.”).

of the spectrum, without the use of incentive compensation, managers have the propensity to appropriate excessive levels of pay and to put forth a sub-par effort in securing shareholder returns. At the other end of the spectrum, with the use of incentive pay, managers purportedly have an incentive to appropriate wealth by damaging the firm and imposing externalities onto economic actors outside of the firm. The potential effects of this are firm failure and systemic instability, both having drastic social consequences. The question that arises from this perspective is where should the line be drawn between the competing consequences of either approach?

PART II-WHAT DOES SUSTAINABLE GOVERNANCE ENTAIL?

CHAPTER FOUR:

Competing Theories of the Firm in a Political-Economic Context

What does sustainable governance entail? Answering this question involves examining the broader significance of a shift in thinking for executive pay, from a corporate law problem associated with self-dealing to a solution for improving performance in the firm. The broader implications of this shift and its underlying impetus are seldom discussed in the literature on compensation reform, yet they represent a fundamental shift in thinking about corporate law, the legal nature of firm, how the rights and responsibilities of these actors should be defined, and the role of law versus the market in reconciling competing claims.

The “entity” metaphor served as the dominant paradigm for conceptualizing managerial power in the post Great Depression era in the context of a “managerialist” framework of rights and powers in corporate law,¹³⁸ against the backdrop of neo-corporatist economic relations between capital, management, and the state, supporting a system of industrial capitalism.¹³⁹ The debate which ensued from within this paradigm, over which constellation of rights and powers best constrains managerial power,¹⁴⁰ underlies today’s debate over executive compensation, as a political contest between labor and capital, raising questions of how these interests should be

¹³⁸ Sciulli, *supra* note 2.

¹³⁹ Bratton, *supra* note 97; Roe, *supra* note 47; See also Philippe Schmitter, “Still the Century of Corporatism” (1974) 36 *Rev of Pol* 85.

¹⁴⁰ Bratton and Wachter, *supra* note 45.

reconciled to facilitate effective economic organization.

The “contractual” metaphor began to take hold in the late 1970’s to address some of the concerns that capital had with the existing system’s perceived deficiencies in the context of a relatively stagnant period of economic growth. This was attributed in part to inefficient production and managerial slack attributable to high agency costs being imposed by social democratic pressures vying for a larger piece of the corporate pie.¹⁴¹

The model which began to take hold was referred to as “shareholder primacy” which was built largely on the existing “managerialist” framework but re-conceptualized how this apparatus functioned and where market-based corporate governance mechanisms needed to be employed to correct its perceived deficiencies and to alter how the benefits and risks of corporate activity were distributed.¹⁴²

These changes occurred during a period of economic liberalization which witnessed the rapid expansion of capital and product markets which placed constraints on managerial discretion,¹⁴³ paving the way for the growth of financial capitalism, the dominant driving force behind corporate strategy since.¹⁴⁴ Focusing not on the externalities of managerial power, but on improving returns for shareholders, this approach removes labor from the equation, focusing on the relationship between capital and management. The debate centers on the extent to which the existing level of managerial discretion under corporate law is accepting of or resistant to market forces which demand increasing levels of efficiency and profitability¹⁴⁵ and how this model can be improved to better address certain aspects of managerial power defined narrowly in terms of efficiency, performance, and current market value.¹⁴⁶

The debate between optimal contracting and managerial power¹⁴⁷ defines how executive

¹⁴¹ For an account of the shift from the entity to contractual metaphors in corporate law see Sciulli, *supra* note 2.

¹⁴² *Ibid.* See also Bratton and Wachter *supra* note 45 (discussing how the contractual metaphor re-conceptualizes corporate law).

¹⁴³ Jacoby, *supra* note 1.

¹⁴⁴ *Ibid.*

¹⁴⁵ This debate is between shareholder primacy versus director primacy contractarians. An example is the ongoing debate between Lucian A. Bebchuk, an advocate of shareholder rights and Stephen M. Bainbridge, an advocate of director primacy.

¹⁴⁶ In essence, this is the claim made by Hansmann and Kraakman in the ‘End of History’ claim. See Henry Hansmann and Reinier Kraakman, “End of History for Corporate Law” in Jeffrey N. Gordon and Mark J. Roe eds., *Convergence and Persistence in Corporate Governance* (Cambridge University Press: UK, 2004).

¹⁴⁷ See Thomas and Hill eds., *supra* note 14 at 1-2 (The authors identify this as the dominant debate in pre and post crisis context).

compensation has been problematized in the period leading up to the crisis.¹⁴⁸ Being historically related in the context of the shift from an industrial neo-corporatist regime to a liberalized market economy dominated by finance capitalism the entity and contractual metaphors define and purport to solve different aspects of managerial power in the firm and represent differing constellations of interests within and around the business corporation, a distinct yet interrelated set of debates, and a differing set of solutions to how economic crises and corporate scandals might be mitigated.¹⁴⁹

In moving forward from the crisis, it is crucial to understand the prospects and consequences of viewing the executive compensation debate from either of these paradigms, to understand how and why these debates might conflict. In viewing this conflict we can either reconcile these differences or if irreconcilable then understand the sets trade-offs involved in overemphasizing either of the approaches they represent.

Before venturing further into such an analysis, it is essential to introduce a framework based on comparative political economy to enlarge the assessment of competing bases for approaching executive pay. The Varieties of Capitalism (“VOC”) literature by Hall and Soskice is suitable to gain a better understanding of the relationship that institutions such as the market and the corporate legal framework have with particular corporate governance orientations, the structure of capital holdings, and the labor management style practiced by firms and to assess the significance and limitations of change within the current paradigm.¹⁵⁰

SECTION A: Varieties of Capitalism Framework

The principle innovations that Hall and Soskice bring to the table from the standpoint of comparative political economy are that economic behavior consists of multiple economic actors engaging in ‘strategic interactions’ in an effort to advance their own interests in a rational way;

¹⁴⁸ Kevin J Murphy, “The politics of pay: a legislative history of executive compensation” in Randall S. Thomas and Jennifer G. Hill eds., *Research Handbook on Executive Pay* (Edward Elgar Publishing: UK, 2012) 11-40.

¹⁴⁹ Bratton and Wachter, *supra* note 45.

¹⁵⁰ See Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001). The following section on the Varieties of Capitalism and its application to corporate legal scholarship consisting of pages 40-49 was originally written by the author in 2013 while in the graduate law program as part of a draft of this thesis. It has been subsequently published in 2014 as part of an article in *Transnational Legal Theory Journal*. See Dezso Farkas, “Re-Evaluating Shareholder Primacy in the Post-Crisis Context: A View from Comparative Political Economy” (2014) 5(2) *Transnational Legal Theory Journal* 314.

that the institutions which condition this interaction are the most important to study; and that firms are the most crucial of these actors due to their overall effect on economic performance.

The key elements of the VOC approach relevant to this examination of executive compensation reform are: 1) its relational view of the firm 2) its hallmark distinction between liberal and coordinated market economies 3) the role it ascribes to institutions, and 4) its conception of institutional complementarities. This approach takes a relational view of the firm which constitutes actors as seeking to “develop and exploit core competencies and dynamic capabilities” by establishing high-quality relationships with a wide range of economic actors and corporate stakeholders.¹⁵¹

Accordingly, this entails ‘coordination problems’ and the firm’s economic success depends on its ability to coordinate in five principle spheres: industrial relations, vocational training, governance, inter-firm relations, and with its employees.¹⁵²

How effectively firms coordinate in the corporate governance sphere determines the availability of finance and the terms on which it can be secured while its ability to coordinate bargaining over wages and working conditions and to ensure that employees are highly competent and cooperative with the firm’s objectives determines the firm’s ability to produce efficiently and profitably.¹⁵³ The other key tenet of the Hall and Soskice approach is its dual model classification of capitalist economies distinguished by how these ‘coordination problems’ are resolved. This distinction between the ‘Liberal Market’ and ‘Coordinated Market’ economy is premised largely on the system of corporate finance utilized and the governance arrangements that develop in the presence of particular institutional constellations.

To overcome the barriers to coordination in Liberal Market Economies (LMEs) firms rely on well-functioning and highly competitive markets to organize relationships based on supply and demand considerations and arm’s length formal contracting.¹⁵⁴ In ‘Coordinated Market Economies’ (CMEs) firms rely on non-market relationships and collaboration as opposed to competition, based on relational contracting and private information to coordinate their

¹⁵¹ Hall and Soskice, *supra* note 150 at 6.

¹⁵² *Ibid.*

¹⁵³ *Ibid.*

¹⁵⁴ Hall and Soskice, *supra* note 150.

endeavours and “to develop and exploit core competencies.”¹⁵⁵ The institutions of the political economy play a crucial role in providing support for how firms resolve coordination problems.¹⁵⁶ It is this relationship between institutions and coordination strategies that forms the basis of the model’s ability to explain why firms in a particular national setting favour a given set of arrangements, pursue a particular set of strategies or develop a particular structure.

According to the authors all capitalist economies “contain hierarchies that firms construct to resolve the problems that cannot be addressed by markets alone.”¹⁵⁷ However, in CMEs firms rely more heavily on strategic interaction and networks (a third type of arrangement) to secure the commitment of the actors involved while firms in LMEs rely almost exclusively on markets and hierarchies. In the corporate governance sphere the coordination problem that initially arises is the potential for shareholders to renege on their capital commitment and undermine an otherwise successful enterprise.¹⁵⁸ This problem is overcome by instituting a Board of Directors which is statutorily mandated in both types of economies.¹⁵⁹ This delegation of the firm’s management to a centralized organ gives rise to a further coordination problem, the potential for managers to act self-interestedly and against the interests of the organization.

In addition to relying on the institution of corporate law and the ex-post solution it imposes through fiduciary duties, actors in LMEs rely on market mechanisms such as the markets for capital and corporate control to monitor and discipline managers while actors in CMEs rely on institutions that facilitate the sharing of information and collaboration such as business associations and trade unions that allow parties to make credible commitments.¹⁶⁰ It follows then that legal institutions in the LME context will tend to support market-based coordination through measures such as disclosure, securities regulation, and rules designed to facilitate arm’s length bargaining and competition such as anti-trust legislation and insider trading rules.¹⁶¹ On the other hand, legal institutions in CMEs will facilitate the sharing of

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid* at 9 (quoting Oliver Williamson, 1985).

¹⁵⁸ A significant function performed by the Board of Directors is to lock-in capital and allow other shareholders and stakeholders to make credible commitments to each other. See Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B. Hansmann, Gérard Hertig, Klaus J. Hopt, Hideki Kanda, and Edward B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: OUP, 2009).

¹⁵⁹ *Ibid.*

¹⁶⁰ Hall and Soskice, *supra* note 150, at 10-21.

¹⁶¹ *Ibid* at 27-33.

inside information and grant legal rights to a wider group of corporate constituents to participate in the firm's oversight.¹⁶²

Hall and Soskice claim that the type of monitoring arrangements prevalent in the political economy will also determine the terms on which investors supply capital.¹⁶³ In the context of well-established and deeply liquid capital markets with rules against insider trading, investors will commit capital based on short-term performance criteria.¹⁶⁴ This is also shaped by their ability to diversify risk through small holdings in multiple companies and to exit the investment. In a context where inside information is available, ownership is closely linked to management and employees have influence over the firm's strategic planning horizon, investors will commit capital on a long-term basis.¹⁶⁵ This is also shaped by the difficulties investors face in exiting the investment and by the presence of business networks that facilitate the exercise of voice instead. In sum, the structure of ownership and the types of monitoring supported by the legal framework influences the terms on which capital is supplied. Accordingly, this also impacts the strategies that managers pursue to attract capital.

While the Hall and Soskice approach sketches out a complex relationship between institutional arrangements and how firms coordinate, it presents a crucial question that cuts across much of the work on comparative corporate governance. Why do firms ultimately gravitate towards one particular set of arrangements and what gives rise to particular institutional constellations in the first place? The explanation provided is that firms attempt to gain advantages stemming from 'institutional complementarities' in that particular national setting, reinforcing the differences between LME's and CME's.¹⁶⁶

Like complementary goods in economics where the price increase of one product affects the demand of the other, institutions of the political economy can mutually reinforce each other's existence if they confer advantages onto a group in the form of efficiencies created by the presence of both institutions.¹⁶⁷ They cite the examples of disclosure and insider trading rules in

¹⁶² *Ibid* at 22-27 (Codetermination laws in Germany allow labor to sit on the Supervisory Board).

¹⁶³ This does not conflict with their previous claim that the terms of capital are influenced by the quality of governance provided by firms, which is true, however the legal framework supports a certain type of governance arrangement (in this case market-based). If firms deviate from this and favour employees more than shareholders (in the case of LMEs) than it should negatively impact their ability to raise capital on favourable terms.

¹⁶⁴ Hall and Soskice, *supra* note 150.

¹⁶⁵ *Ibid* at 10-11 and 21-33.

¹⁶⁶ *Ibid* at 17-21.

¹⁶⁷ *Ibid*.

LMEs reinforcing the returns that investors can make trading on the stock market and of fluid labor markets and less employee protection being complementary to a highly developed stock market and higher levels of market-based coordination.¹⁶⁸

Yet Hall and Soskice point out, it is not the presence of a particular set of institutions alone that determine the precise strategies pursued. Even in the presence of widespread ownership and deeply liquid capital markets, multiple equilibriums can exist, on which firms can coordinate. In other words, the presence of these institutions alone do not always dictate that investors will commit capital only on a short-term basis and will prefer exit over voice.¹⁶⁹

Hall and Soskice identify history, culture and informal rules as having influence over which outcomes are pursued more prevalently.¹⁷⁰ This is due in part to a nation's political economy being bound up with its history and culture which includes political contests or previous forms of cooperation between corporate constituent groups. The tensions between labour and finance in the U.S. for instance have been well documented. The waxing and waning of capital markets as the principle ordering mechanism for corporate relations has been to a large extent shaped by the political contest between capital and labour.¹⁷¹

This has important implications for understanding the trajectory and development of U.S. corporate governance since the late 19th century which has fluctuated within the LME context between a highly liberalized form of market capitalism in the period leading up to the Great Depression followed by a period of coordinated industrial capitalism which began to shift in the 1980's towards financial capitalism characterized by "the self-regulating market writ large."¹⁷² It militates towards the view that shareholder primacy is not necessarily the ideal solution for corporate law's perceived failures, but instead the end result of an evolutionary trend determined by an outcome of political contests and their resulting legal institutional matrices.

¹⁶⁸ *Ibid.*

¹⁶⁹ Pension funds in the US often hold large blocks of companies and choose to exercise voice over exit. Also, in the LME context both short-term and long-term investment is feasible. Short-term investment was less prevalent in the US context between the Second World War and the 1980's before financial development began to take hold. See Jacoby, *supra* note 1.

¹⁷⁰ While financial development was brought-on by changes in institutional structure such as the expansion of capital markets and the emergence of the new market for corporate control, the equilibriums on which firms coordinated which were often based on short-term gains were also a product of political forces seeking to establish a particular market order and the outcome of a historical contest between the labor union, the business lobby, and the state. This contest was also ideological in the realm of economic and corporate governance theory which influenced the coordination strategies of economic actors. See Jacoby, *supra* note 1.

¹⁷¹ Jacoby, *supra* note 1.

¹⁷² Deakin, *supra* note 4.

In sum the direction of causality set out by VOC is that historical, legal and political actions shape the overarching institutional structures of the political economy, such as capital markets, which shape the opportunities available to firms which in turn conditions the strategies they pursue in areas such as corporate governance and employee relations. Accordingly, the presence of widespread ownership and liquid capital markets, rules that support market-based monitoring in corporate governance, and weaker protections for employees should make it advantageous for firms to coordinate on strategies that yield short-term gains as opposed to longer-term projects and likewise gravitate away from working in close partnership with their employees.

However, if multiple equilibriums can exist and firms coordinate more prevalently on some of these due to history, culture, and the outcome of political contests, the question remaining is whether these factors can generate significant differences in what equilibriums firms can coordinate on within a particular national context? Can this explain swings in the prevalence and dominance of market-based monitoring mechanisms and corporate governance norms in the LME context? Moreover, what is the potential for variation within this framework and to what extent can and should the market be constrained? From a broader perspective of political economy, executive compensation in the post-crisis era is located in this debate.

SECTION B: Application of VOC to Corporate Legal Scholarship

The Hall and Soskice approach to VOC has provided fertile ground for corporate legal scholarship to examine national divergences in corporate governance practice. Amongst the more notable of these has been the work of corporate legal scholar Mark J. Roe on the ‘Political Determinants of Corporate Governance.’¹⁷³ Carrying through with the overarching theme that politics, society and the ordering of markets are interrelated Roe begins with the proposition that for a nation to produce it must attain a level of social peace otherwise “investors invest reluctantly, or not at all, and the factory is not built.”¹⁷⁴ He relates this macro-political claim to the firm’s micro-economic structure and to the micro-political dynamic between owners, managers and employees, acknowledging that these particular interests are often juxtaposed in

¹⁷³ Roe, *supra* note 47.

¹⁷⁴ *Ibid.*

the course of production. Social conflict between these groups, he continues, leads to political settlements which impact directly the types of corporate governance arrangements pursued in a particular national economy. The aim of Roe's study is to examine the effects of one such political determinant, labour's influence on management's strategy and how it determines ownership structure in a national economic setting. His principal claim is that the manner in which social conflict has been settled "powerfully affects how firms are owned and how authority is divided [and that] politics at times requires boardrooms and ownership structures to be a certain way... making [a particular structure] less likely to arise and prosper."¹⁷⁵

He argues that the politics and legal framework of such an economy "wedges open the gap between shareholders and managers by pressing managers to expand, to avoid downsizing, and to go slow in taking risks that would affect the work place."¹⁷⁶ This generates managerial agency costs for shareholders who gravitate towards a concentrated ownership structure as a means of controlling them. In LMEs, politics and the legal framework support shareholder-oriented goals and mechanisms that align shareholder and manager interests. In fact, he suggests that for diverse ownership to have ever taken hold in the U.S. weak social democracy was a necessary precondition.¹⁷⁷ While this specific claim has been highly contested, it illustrates more broadly that certain regulatory climates are perhaps more conducive to the persistence of certain ownership patterns and hence governance strategies.

The economic liberalization of the past three decades and changes to labour market regulation permitted immense reorganizations of corporate ownership structures to occur across LMEs wreaking havoc onto the organization of labour.¹⁷⁸ However, the question that remains to be answered, is to what extent does the presence of certain ownership structures necessitate particular orientations in corporate governance? For instance, if managers endeavour to work in partnership with their employees in a broadly LME context and give them a larger piece of the corporate pie than shareholders might otherwise expect, does this necessarily translate into a push-back from shareholders to cut costs and maintain workplace flexibility? Roe's theoretical

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

¹⁷⁷ This is also consistent with Jacoby's claim that for the self-regulating market to be established as a corporate governance mechanism, institutions with a social democratic function need to be dismantled. Consequently, his definition of the self-regulating market encompasses deeply liquid capital markets and the market for corporate control to which corporate governance mechanisms are tied. Jacoby, *supra* note 1.

¹⁷⁸ Such were the changes in Australia from in the 1990s and 2000s. See Mitchell et al. *supra* note 60 at 164.

application of VOC to corporate governance seems to suggest that it might.

Roe posits that firms operate in environments where product and capital markets are either weak or strong. Weak product markets which lack competitive forces enable firms to raise the cost of their products and to reduce their supply to extract monopoly rents from their customers. Under competitive circumstances, the firm's revenue from its product sales covers its basic costs and the normal level of profit it needs to pay to capital. Consumers receive a surplus by obtaining a quality good at a competitive price. By reducing supply, firms lower their overall costs and by concomitantly raising prices they capture from the consumers who are still willing to buy at the higher price, this surplus. Consumers who cannot afford to buy are deprived from having access to the product in the marketplace, the so-called 'monopolist's sin'. The rent captured is referred to as the 'monopolist's rectangle' and according to Roe, it gives rise to political contests between labour, management and capital.

These contests impact not only how the firm is run but also corporate governance structures, laws and practices. Weak market pressures and the prevalence of monopoly rents loosen constraints on managers to produce efficiently and to favour the interests of shareholders, which they would otherwise be inclined to do where profits margins are narrow.¹⁷⁹ In the absence of such pressures management's interests are highly compatible with those of employees who favour a less aggressive pursuit of profits, lower levels of risk-taking, and a greater share of corporate wealth than otherwise obtainable. Thus coalitions are formed within the firm between labour and management on the one hand or management and shareholders on the other, which fluctuate based on the strength of market forces.

According to Sanford Jacoby, the period between the Great Depression and the 1980's was characteristic of a coalition between labour and management against capital which was marked by the lessened ability of shareholders to earn high levels of short-term profit from large industrial corporations who were managed predominantly for the long-term.¹⁸⁰ Product and capital markets were less developed at the time. The levels of wage inequality between the elite class of managers who ran these firms and the masses of employees who worked on the front line, was significantly lower than present. Corporate governance arrangements such as

¹⁷⁹ Roe, *supra* note 47 at 125-133.

¹⁸⁰ Jacoby, *supra* note 1.

performance-based pay incentives were less prevalent, which enabled higher levels of discretion, which in turn afforded protections against the exploitation of labour by capital.

Roe suggests that pressures from labor to capture rent and lessen the extent to which managers run the firm in shareholders' interests generate high levels of costs for shareholders in the form of 1) rents directly extracted by managers (2) rents given by managers to labour and 3) slack in managerial performance which impacts the generation of shareholder wealth.¹⁸¹ On the one hand, a modest managerial rent in corporate control can yield large monopoly rent losses to the shareholders. This is typically what legal rules designed to control self-dealing and conflict of interest transactions are designed to address. Fiduciary duties for instance prevent managers from dispensing with corporate assets for their own or other constituents' interests. On the other hand, a small managerial rent resulting from slack could result in a huge monopoly rent in forgone profits for the shareholders. Corporate law's traditional legal mechanisms and its entity-centric structure, it is argued, prevent this type of rent extraction from being effectively addressed and weak markets preclude shareholders from controlling these types of agency costs.

As Roe indicates, "one powerful means to reduce managerial agency costs is for the stockholders to act cohesively in a block."¹⁸² This in turn explains why ownership patterns in Germany tend to be more concentrated. With co-determination being mandatory in large public firms and capital markets being less developed, capital in Germany, at least in theory, organizes into large blocks to ultimately secure less aggressive but steady long-term returns, maintaining a semi-stable equilibrium between labour, capital and management. However, where widely held ownership structures and their concomitantly supporting legal framework have been historically present and embedded in the political economic framework, it is less likely, in theory at least, that ownership structures would develop along these lines. Instead, the legal framework develops to compliment such ownership by providing greater protections to investors, placing greater demands onto managers to favour capital.

Roe posits that in such a context where active product and capital markets create a competitive environment, managerial slack is constrained and the potential for labour to compete

¹⁸¹ Roe, *supra* note 47 (noting that "the monopoly yields a bigger pot of value (bigger, that is, than the pot an equivalent competitive firm would produce) into which managers can stick their fingers."); See also *Ibid* at 129 (noting that "there is evidence that market concentration reduces productivity and that competition enhances it").

¹⁸² *Ibid.*

for and extract a share of monopoly rents is virtually reduced, due to a lack of the monopolist's rectangle. In effect, labour is removed from the equation and precluded from competing for a greater share of the corporation's wealth due to the narrower scope of profit available to shareholders. The contest within the firm for a greater share of resources becomes predominantly between shareholders and management, although labour still engages with fending off the imposition of risk and other externalities associated with aggressive profit-seeking. However, in this context shareholders are less concerned with capturing a maximum share of rents, as their entitlement to them is viewed as a given. Instead, the focus is on expanding the corporate pie through greater efficiency and risk-taking. However, the extent to which increasing returns to shareholders represents the creation of increased corporate value is questionable.

In sum, the contest over corporate wealth in the firm becomes a struggle between capital and management to ensure managers perform at a maximum level. While corporate law's role in preventing rent extraction still holds relevance, if profit maximization is achieved, excessive rent seeking becomes a secondary concern. Effective performance incentives become the key mechanisms for making managers more profit-oriented. This in turn equates to effective corporate governance, rendering corporate law redundant, as some have suggested.

However, what remains unaddressed is the potential for negative consequences if these pressures to maximize profit exceed certain limits, which are unclear. Acting in both their own and shareholders' interests, managers can attempt to capture rents from the firm itself by sacrificing re-investment into long-term growth, impacting the firm's ability to provide long-term stable employment and to invest in production locally. The 'Political Determinants' literature inadequately addresses the extent to which the erosion of such benefits undermines the prospects for long-term sustainable firm governance. In other words, where is the line between a sustainable versus unsustainable governance approach and how it should be reflected in law?

CHAPTER FIVE:

The Organizational Model of the Firm

It is necessary herein to deconstruct the legal/organizational model of the firm to locate the key facets of the sustainable governance debate, how they have evolved, the aspects of managerial power they seek to address and the trade-offs inherent in this approach. Before laying out how this model is constituted, it is important to review the political-economic functions performed by corporate law. To then locate these debates, the organizational model of the firm can be examined across three distinct layers, its structural, legal and normative components which shape the parameters of managerial power. Once identified, these debates can be correlated with the competing narratives of the executive compensation debate to realize the deeper implications of competing solutions to executive compensation reform.

The entity model of the corporation is rooted corporate law's traditional role of defining power in the corporation, the legal responsibilities of those who exercise it and the relevant standard of behavior.¹⁸³ It posits the corporation as an organizational structure and the law of corporations as serving a constitutional function.¹⁸⁴ By creating a separate entity with a collective set of interests embodied in the corporate form with an internal governance structure which determines how and to what end the corporation's resources will be deployed, corporate law provides a legal solution to a set of organizational problems.¹⁸⁵ It represents a particular configuration of relationships between the law, markets and the state and between labor, capital and management, supported by a system of legal rights, processes, and structures that enable these constituents to overcome their competing economic and normative issues.¹⁸⁶

¹⁸³ For a detailed discussion and analysis of the entity metaphor and the role and responsibilities of the corporate judiciary in monitoring how managers govern public corporations see Sciulli, *supra* note 2.

¹⁸⁴ See Eisenberg, *supra* note 5 ("corporate law in constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those participating in the institution, and to delimit the powers of the institution [with regard to] the external world.")

¹⁸⁵ This view supports a policy role for company law in the context of a neo-corporatist economic paradigm where the State not only is involved not only in shaping the role of business along nationalist economic lines but in disseminating public interest norms into private law to achieve a particular outcome. The full range of mandatory norms in corporate legal statutes including the corporate entity itself, fiduciary duties, and the rights and powers of shareholders can be viewed along these lines as opposed to an extension of property rights and the freedom to contract that the state merely provides basic protections for.

¹⁸⁶ John W. Cioffi, "Restructuring 'Germany Inc.': The Politics of Company and Takeover Law Reform in Germany and the European Union" (2002) 24(4) *Law and Policy* 355 at 356 (noting that "By creating a basic corporate structure that integrates three constituencies, company law plays a crucial mediating role between the norms of securities regulation and those of labor

SECTION A: Corporate Law's Role in Economic Organization

By giving rise to the basic corporate form and its internal governance structure and powers, corporate law enables a wide array of investors in the context of a regulated market exchange to pool their resources and commit capital on terms for which ordinary contracts cannot provide.¹⁸⁷ By the 1930's the corporate landscape in the United States consisted of giant industrial conglomerates that were owned by a large and widely dispersed base of small investors. Unlike business partnerships or closely-held corporations who were managed by their owners or delegates, these entities were run by a professional cadre of elite managers who were separated from the shareholder base, providing them with vast control over large pools of resources.¹⁸⁸ By supplying capital on uncertain terms of repayment, these constituents played a crucial role in enabling giant corporations in the post- Great Depression era of industrial capitalism to innovate, engage in necessary risk-taking, and to meet their fixed obligations.¹⁸⁹

However, these groups often had diverging interests and risk tolerances.¹⁹⁰ By providing a standard template for organization, insulation of management from capital and a guaranteed means of locking in capital, corporate law provided a vehicle for capital, labor and other groups to pool their resources and balance their competing interests.¹⁹¹ This form of economic organization offered a more efficient alternative to single market transactions.¹⁹² Labor market regulation influences corporate managers to maintain certain standards and incur certain costs while capital markets influence managers to focus on efficiency and on securing the benefits from the exploitation of labor.¹⁹³ The firm's governance organ acts as an intermediary to balance

relations law... Thereby company law contributes to the systemic coherence essential to both a dynamic and competitive economy and a functional legal system”).

¹⁸⁷ John Armour, Henry Hansmann and Reinier Kraakman, “The Essential Elements of Corporate Law”, *European Corporate Governance Institute, Law Working Paper No. 134/2009* (2009), Online: SSRN, <<http://ssrn.com/abstract=1436551>> (noting that the essential functions performed by corporate law are perpetual existence, the inability of shareholders to demand their money back and jeopardize the venture, protection for shareholders from liability for debts and negligence, a governance organ with partially independent decision-making capacity).

¹⁸⁸ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, 10th ed. (New Jersey: Transaction Publishers, 2009) (noting that the existence of widely held public corporations gave rise to a managerial class that enjoyed unfettered discretion over vast sums of resources in society).

¹⁸⁹ Bratton, *supra* note 97.

¹⁹⁰ Cioffi, *supra* note 186

¹⁹¹ Henry Hansmann and Reinier Kraakman, “What is Corporate Law?” in Kraakman et al., *supra* note 158 at 11-13.

¹⁹² For an explanation of this claim see Oliver E. Williamson, “[The Economics of Organization: The Transaction Cost Approach](#)” (1981) 87(3) *Am J of Soc* 548; see also Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975).

¹⁹³ Cioffi, *supra* note 186.

these interests so that either party can commit their resources over the long-run.¹⁹⁴ Power in the firm is balanced between capital and management via the structure of rights.¹⁹⁵ This leaves a high level of discretion for the Board regarding major aspects of the corporation's existence including transactions, structure, strategy, how its resources are utilized and how it deals with outside stakeholders.¹⁹⁶ This is further constrained by legal norms of behavior through fiduciary duties which define and shape discretion.¹⁹⁷

SECTION B: Structural Determinants of Managerial Power

The legal structure of corporate law gives rise to managerial power and establishes its parameters. Through defining the decision-making rights of shareholders, corporate law balances power between management and capital.¹⁹⁸ In the Anglo-American system, the broad decision-making power of the Board is an outcome of how shareholder rights are structured.¹⁹⁹ The scope of directors' decision-making power is defined by de jure and de facto limits on shareholders' voting, appraisal and proxy rights. Where the application of these rights is unclear or imprecise, fiduciary duties, as interpreted by the courts, attempt to fill in the gaps.²⁰⁰

In LMEs corporate law provides shareholders with the right to vote on major structural transactions including dissolution, the sale of substantial assets and major restructurings. With exceptions, the right to initiate proposals rests with the Board.²⁰¹ Shareholders also have the right to sell or transfer their shares without the Board's consent with some restrictions²⁰² and have the right to initiate and vote on dissolving the corporation if all consent.²⁰³ However, there are restrictions on shareholders' ability to influence ordinary business operations.²⁰⁴

Delaware corporate law further provides shareholders with a right to require the firm

¹⁹⁴ See Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law" (1999) 85(2) *Virginia L R* 248; See also Stout, *supra* note 55.

¹⁹⁵ Eisenberg, *supra* note 5; Romano, *supra* note 15.

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid.*

¹⁹⁸ Under German corporate governance law, this includes workers' rights to nominate and elect their own representatives onto the Supervisory Board. See Hans Joachim Mertens and Erich Schanze, "The German Co-Determination Act of 1976" (1979) 2 *Journal of Comparative Corporate Law and Securities Regulation* 75.

¹⁹⁹ Eisenberg, *supra* note 5; Romano, *supra* note 15.

²⁰⁰ Eisenberg, *ibid.*

²⁰¹ *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 271(a).

²⁰² *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 202.

²⁰³ *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 275 and s 275(c).

²⁰⁴ *Ibid.*

repurchase their stock at fair market value.²⁰⁵ Different jurisdictions have either expanded or curtailed this right.²⁰⁶ As a remedy available to shareholders who dissent against fundamental or structural changes however, the right in practice, is limited by procedural barriers.²⁰⁷ Proxy rights in Delaware derive both from corporate statute and federal securities regulation.²⁰⁸

The right is two-fold. First, shareholders can nominate and elect members to the Board, however the right to nominate in practice is curtailed.²⁰⁹ Second, shareholders can initiate proposals for matters other than election such as the removal of directors, dissolution and certain structural transactions.²¹⁰ Some proposals can be voted on by the shareholders while others require Board approval.²¹¹ In practice, directors have numerous advantages over shareholders in nominating and electing members to the Board, such as greater access to the corporation's proxy machinery and resources to wage proxy battles and elect an incumbent director.²¹²

SECTION C: The Debate Over How to Structure Rights

The question of how to structure rights is at the center of an ongoing debate over corporate law reform. The key issue at stake is how to effectively constrain corporate power and which constituent group is ideally suited for this role. Three normative models exist, each having strengths and weaknesses.

I. Shareholder Democracy

This model was canvassed as a post-Great Depression alternative and underpins the shareholder rights movement of today. It posits that shareholders are ideally situated for constraining corporate power by having greater decision-making power than management.²¹³ Placing more power in the hands of shareholders disperses the concentration of power, democratizing corporate decisions with far-reaching effects and creating less conflict between

²⁰⁵ Eisenberg, *supra* note 5 at 70-84.

²⁰⁶ *Ibid.*

²⁰⁷ *Ibid.*

²⁰⁸ See Section 14 of the *Securities and Exchange Act 1934*, 15 U.S.C. § 78a.

²⁰⁹ *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 212.

²¹⁰ *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 141(k), s 271, s 275.

²¹¹ Eisenberg, *supra* note 5.

²¹² *Ibid.*

²¹³ *Ibid.* See also Bayless Manning, "Corporate Power and Individual Freedom: Some General Analysis and Particular Reservations" (1960-61) 55 *Nw. U. L. Rev.* 38 at 42.

corporations and societal welfare. While this lessens the concentration of power in a few hands, some have suggested that shareholders are more interested in profit than corporate managers, creating a greater conflict between corporate power and civil society.²¹⁴

II. Client Group Participation

This model posits that various constituents including labor, customers, suppliers and government could have joint decision-making power over corporate affairs, such as a sale or merger of an enterprise.²¹⁵ This would give client groups an opportunity to vote in a manner which represents how corporate decisions impact their well-being. It could also serve as a counterbalance to intense profit-seeking which conflicts with societal welfare. However, client groups would more than likely vote to serve themselves which could also conflict with the corporation's goal of economic longevity.²¹⁶ If we accept that corporations exist to make a profit and need growth to prosper, groups such as labor might impede this goal by voting on transactions which favor less productivity and an unsustainable share of corporate wealth.

III. Managerialism

This model closely resembles corporate law's existing structure of rights. It concentrates immense power in the hands of managers.²¹⁷ Despite allowing large scale economic organization to occur, it has several weaknesses. One is the broad decision-making power of directors which concentrates power.²¹⁸ Widely dispersed shareholders are disinterested in exercising control and in fact are powerless over most decisions. In terms of major structural decisions and director elections, directors wield enormous power over the proxy process by controlling votes.²¹⁹ Directors might own voting shares which can be exercised against new candidates who are already disadvantaged.

²¹⁴ Eisenberg, *Ibid.*

²¹⁵ *Ibid.*

²¹⁶ See Beardsley Ruml, "Corporate Management as a Locus of Power" (1951) 29 *Chi Kent LR* 228.

²¹⁷ Eisenberg *supra* note 5.

²¹⁸ Eisenberg, *supra* note 5, 25-29.

²¹⁹ *Ibid.*

SECTION D: The Legal Determinants of Managerial Power

The existing structure of rights under corporate law creates wide discretion for managers when governing the corporation, entrenching managerial power in the corporate form. This creates positions of trust and dependence, requiring management's power to be defined and constrained by law.²²⁰ Corporate law shapes the parameters of managerial action, primarily through prescribing management with fiduciary duties, owed to corporation. The application of fiduciary duties is contextual and is based on regulating particular types of behaviors in a range of situations. As Professor Kenneth Scott explains:

One can postulate a continuum of situations involving conflicts of interest between controlling managers and owners, with the conflicts becoming less sharp (and perhaps the legal rules less useful). At one extreme would be outright theft, embezzlement, and misappropriation; without effective legal (usually criminal) sanctions in these cases, only the gullible would part with their money. A somewhat less transparent form of achieving the same end is the self-dealing transaction between the manager and his firm. By buying too low or selling too high, the controlling party transfers wealth from the firm to himself, but the picture can be confused by intricate transactions in nonstandard assets or subject to varying degrees of price unfairness. Enforcement becomes more difficult, but still seems essential if agency costs are to have any bound. The appropriation of corporate opportunities, excessive managerial compensation, and consumption of managerial perks can be still more judgemental, and probably the legal rules less effective, but the order of magnitude is also often less.²²¹

Two principle contexts, where longstanding debates over controlling managerial power can be located, are: A) the context of corporate takeovers, dominated by competing views on whether a duty exists to maximize shareholder wealth and B) the context of deploying the corporation's assets, dominated by the doctrine of corporate waste. Each represents a set of trade-offs for how competing constituent interests can be reconciled and the consequences this has for managerial power. Both areas implicate the duties of loyalty to the corporation and the duty of care, juxtaposed against a broad interpretation of the business judgment rule.

The duty loyalty is a mandatory norm of conduct and is owed to the corporate entity. In breaching this duty, directors can be held personally liable for damages which arise in connection with the breach. The duty of loyalty “most fundamentally requires that a corporate fiduciary’s actions be undertaken in the good faith belief that they are in the best interests of the corporation

²²⁰ See Sciuilli, *supra* note 2; Baums and Scott, *supra* note 95; Eisenberg, *supra* note 5.

²²¹ Kenneth E. Scott, “The Role of Corporate Governance in South Korean Economic Reform” (1998) *10 Journal of App Corp Fin* 8.

and its stockholders.”²²² While corporate law has typically protected valid business judgment from civil liability and judicial review, it imposes the condition that managers must exercise their powers in accordance with a valid business purpose and not for personal gain.²²³

The duty of care exists to ensure that management operates the firm above a certain standard of conduct. As Baums and Scott explain:

A second aspect of the fiduciary duty of officers and directors comes under the heading of the duty of care, which requires them to act “with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” The standard as thus expressed is one of reasonable or ordinary diligence, knowledge and skill, and would seem to create possible civil liability for ordinary negligence.

Fiduciary duties are enforceable through a derivative action, available in the context of self-dealing and corporate decision-making that lacks a valid business purpose.²²⁴ This includes blocking a transaction which creates value for shareholders in order to protect employee interests without a proportional benefit to the firm,²²⁵ or selling the entire assets of a corporation and diverting the funds to employees to compensate them for their job losses as opposed to distributing the proceeds to shareholders.²²⁶ Employees in the latter example benefit but cannot reciprocate because their jobs might no longer exist. There is no valid business purpose connected to giving employees this compensation. The derivative action enables shareholders to discipline managers on behalf of the firm and to protect their own interests in the process.²²⁷

In sum, the legal tools of corporate law are not a mechanism for achieving high levels of performance but for ensuring managers do not appropriate the firm’s assets, damage the firm in the context of deploying its resources, or resolve conflicting interests in a manner that neglects a valid corporate purpose, in which the need to make some level of profit is reflected.

²²² Leo E. Strine, Jr., Lawrence A. Hammermesh, R. Franklin Balotti, Jeffrey M. Gorris, “Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law” (2009) 93 *Geo L J* 629.

²²³ *Ibid.*

²²⁴ For an analysis of this shareholder remedy in the Canadian context see S.M. Beck, “The Shareholders’ Derivative Action” (1974) 52 *Can BR* 159. Under Delaware corporate law the derivative suit is a shareholder right granted under the *Delaware General Corporation Law*, Title 8, Chapter 1 of the Delaware Code, s 327.

²²⁵ These cases involve shareholders alleging that management’s defence to a takeover bid breaches their fiduciary duties to the corporation because it stands in the way of short-term value creation.

²²⁶ These were the facts in *Kelly v. Electrical Construction Co.*, 1907 CarswellOnt 248, 16 O.L.R. 232 (Ont. C.P.).

²²⁷ See Thomas P. Kinney, “Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers” (1994) 78(1) *Marquette L R* 172.

I. Takeover Context

While change of control transactions implicate both structural and legal constraints on managerial power, courts have been the battleground for settling competing claims in this context. They involve an unsolicited bid from an acquiring entity for a target firm who is underperforming in the market. Approval of the transaction is sought directly from the shareholders and a premium is paid for their shares, often substantially above market value. The acquiring entity's management calculates, despite the premium being offered, that the purchase is still a bargain given the efficiencies that can be found by restructuring the firm. This often involves substantial cost reductions, the sale of major assets or subsidiaries, the shedding of various operations and the closing down of plants. While takeovers implicate the right of voting class shareholders to approve major transactions and their right to remove and re-elect the Board, an issue involving fiduciary duties arises over the Board's use of defensive tactics in response to a hostile takeover bid. Views diverge over the extent to which maximizing wealth in the takeover context is synonymous with the corporation's best interests and whether the duty of loyalty in fact extends into a duty to maximize shareholder wealth.²²⁸

There are two competing theories, the shareholder interest hypothesis and the management entrenchment hypothesis. The first theory holds that defensive tactics are used beneficially by management because shareholders would prefer to hold out so that management can defeat a low bid, bargain for a higher offer, or attract other bids.²²⁹ This is based on the view that takeovers are exploitative and fail to create the high value purported. The following reasons have also been advanced to justify the right of target management to defend a takeover: 1) tender offers fail to increase welfare for shareholders over the long-term 2) target shareholders gain more value when the hostile bid is defeated and 3) target managers have obligations to other groups who might be negatively impacted.²³⁰

²²⁸ Lawrence A. Hamermesh, "Corporate Democracy and Stockholder-Adopted Bylaws: Taking Back the Street?" (1998) 73 *TUL L REV* 409 (arguing against poison pill-limiting bylaws); Brett H. McDonnell, "Shareholder Bylaws, Shareholder Nominations, and Poison Pills" (2005) 3 *BERK BUS L J* 205 (arguing for poison-pill limiting by-laws).

²²⁹ Jeffrey Macintosh, "The Poison Pill: A Noxious Nostrum for Canadian Shareholders" (1993) 15 *Canadian Business L J* 276.

²³⁰ See Frank H. Easterbrook and Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1982) 94 *Harv L R* 1161.

The second theory holds that defensive tactics are used abusively by management as a means to entrenching their positions.²³¹ If takeovers result from a potential value gap between the current level of agency costs and the acquirer's plans to restructure the firm, then managers surely face loss of their employment.²³² Thus, managers have an interest in perpetuating their power and insulating themselves from the market for corporate control which consists of firms seeking to exploit new found efficiencies in large public corporations. Proponents of this view argue that fiduciaries duties should be interpreted as a duty to maximize shareholder wealth.

State courts in the U.S. have typically favoured the latter theory. Although, under Delaware jurisprudence, courts have upheld the rule in *Revlon Inc. v MacAndrews & Forbes Holdings Inc.*,²³³ requiring management's duty to the corporation to shift from canvassing alternatives to a sale to maximizing shareholder value, once the company's sale has become inevitable.²³⁴ The functioning of a market for corporate control and its effect on managerial behaviour can be further understood by looking at the third layer of factors, the set of normative determinants which exist outside of corporate law's reach.

II. Corporate Waste Context

As discussed, the development of the corporate waste doctrine is characterized by a tension between protecting the corporation from management's improper use of corporate resources on the one hand and insulating managers from liability for failed risk driven by shareholders' hindsight bias on the other. The weakness of this balance is the moderate protection it provides against managerial rent-extraction and its failure to address the problem of managerial slack for shareholders. However, as discussed, this balance necessarily insulates shareholders from the firm's central governance organ by upholding managerial discretion and enabling directors to balance competing claims in the corporation's best interests.

The executive pay debate, when located in the organizational model of the firm, necessarily implicates a broader debate over the trade-offs inherent in the corporate waste doctrine on the one hand and the inability of this legal tool to address the problem of poor

²³¹ Macintosh, *supra* note 287.

²³² *Ibid.*

²³³ *Revlon Inc. v MacAndrews & Forbes Holdings Inc.* 506 A.2d 173 (Del. S.C., 1985).

²³⁴ *Ibid.* For a discussion of the *Revlon* rule see Clark W. Furlow, "Reflections on the *Revlon* Doctrine" (2009) 11(3) *U of Penn J of Bus L* 519.

managerial performance and rent diversion on the other. This can be further viewed as a conflict arising within the collective entity between interests. While excessive pay in this context can constitute mismanagement (a breach of duty of care) or self-dealing (a breach duty of loyalty), the question raised is what standard should directors be held to?

One scenario is to hold management strictly accountable to the profit motive when setting executive compensation and ensure that executive pay spurs high levels of performance despite its grossly disproportionate size to workers' pay. Doing so could have negative consequences for social welfare by contributing to inequality. If management is motivated to seek out new efficiencies, it could result in job cuts, wage freezes, and a reduction in benefits.

The Board has power over two essential variables, the overall size of the compensation and the corporate goals to which it corresponds.²³⁵ The corporation's labor constituency has an interest in constraining both what the CEO makes and such corporate goals.²³⁶ In general, labor is opposed to large bonuses which reward gains in share price and risk-taking which might be synonymous with reductions in the workforce, the scaling back of benefits and a shift to more flexible labor arrangements.²³⁷

Shareholders on the other hand benefit most from a norm that requires directors to do what is economically superior for the corporation. Executive pay that encourages high efficiency improves competitiveness and enhances firm value.²³⁸ This is consistent with the firm's profit motive. Yet doing so entails that directors suppress the corporation's social role. However, approaching executive pay as an equity issue between workers and executives might not result in sufficient accountability to the profit motive.²³⁹

Notwithstanding the broad limits on executive compensation under both the doctrine of waste and business judgement rule, there is currently no legal standard for balancing competing interests when setting executive pay. The debate over which goals to reward and how, ultimately falls outside of corporate law's reach. The question then is what are the consequences at either end of the spectrum for how managerial power is constrained?

²³⁵ See Romano, *supra* note 15.

²³⁶ See Hall and Soskice, *supra* note 150.

²³⁷ *Ibid.*

²³⁸ Roe, *supra* note 47.

²³⁹ This is a key claim of optimal contracting theorists.

SECTION E: The Normative Determinants of Managerial Power

The debates over what directors' duties should be in the takeover context and which goals are appropriate to reward in the corporate waste context both have dimensions outside of the narrow legal debates discussed above. At the operational level of the firm, these debates have fundamental implications for determining which management orientation should prevail. It is essential to recognize two points regarding these contexts.

One is the importance of identifying what drives particular executive pay arrangements at this level, their consequences for how managerial power is constrained and how they should be constrained, if at all. Two is recognizing the analogous points between the executive pay debate and the evolution of the takeover debate, namely the response of corporate law to the negative effects of the market for corporate control as compared with the negative externalities of incentive pay and the potential for corporate law to provide a solution.

Outside of the corporate law box, directors' discretion is subject to forces competing over which interests managers should consider. The primary drivers of this orientation are varying norms of directorial conduct driven by market forces. These range from the shareholder value norm to more stakeholder-inclusive norms underpinned by market versus entity-based norms of directorial responsibility. The level of risk taken and the time horizons set by management are economic considerations that hinge on market conditions, the availability of inputs, managerial skill, capital market pressures and the pervasiveness of particular norms. Courts typically will not second guess these decisions and are reluctant to involve themselves in running business.²⁴⁰

While shareholders are vulnerable to exploitation, they also act as bearers of residual risk and accept this position with the understanding that if management acts with a valid corporate purpose, which includes profit maximization, then shareholders could realize above average returns if the firm is efficient. The question that remains is, how do shareholders ensure that managers perform adequately?

Market based mechanisms are available to shareholders for addressing the performance issue. These are disclosure rules, the ability to sell in a deeply liquid capital markets exchange,

²⁴⁰ This explains the reluctance of courts to second guess business judgement in corporate waste cases. High executive pay can sometimes be connected with recruiting top talent and setting high expectations for performance that never materializes due to unforeseen circumstances. See Murrey, *supra* note 72.

and the ability to diversify their holdings. There are prospects in theory for the Board to act as a protector of shareholders' interests in "maintaining good performance and limiting self-dealing and other private benefits".²⁴¹ While director elections and the proxy contest in the closely held corporation is an effective means of influencing the role of the Board, in the widely held firm, the Board must be influenced by other means.²⁴²

The basic assumption of director orientation is that "directors will meet their legal and moral obligations out of sense of duty and internalized norms".²⁴³ At the very least they seek to preserve their reputations.²⁴⁴ However, there is no clear imperative for whose interests should take priority.²⁴⁵ Directors are also motivated by the desire to keep their position and might be inclined to serve the interests of those who put them on the slate which in the closely held corporation might be the majority shareholder while in the widely held firm the CEO.²⁴⁶ In the absence of strong market pressures, labor could have a significant influence in management orientation, as labor's interests in low risk, stability and slow growth are compatible with management's. Three roughly categorized modes exist for the role that the Board can play in operating the firm.²⁴⁷ They are identified as the following:

1. An advisory role to top management in which the Board attempts to oversee management and ensure its compliance with the law but otherwise defers to its judgement in how it balances interests in conjunction with a valid corporate purpose.
2. A shareholder agent role in which the Board acts only on shareholders behalf, replacing under-performing managers and implementing contractual measures that ensure maximum performance and shareholder returns.
3. A stakeholder role in which the Board consistently reconciles the interests of those parties that are regularly impacted by the firm's actions.

²⁴¹ Baums and Scott, *supra* note 95 at 10.

²⁴² This is due to the collective action problem between small and widely dispersed stockholders and the inability and unwillingness of widely held shareholders to coordinate. See Eisenberg, *supra* note 5 at 30-68. The two non-legal mechanisms for influencing managerial performance are the market for corporate control and incentive compensation. See Baums and Scott, *supra* note 95.

²⁴³ Baums and Scott, *supra* note 95 at 14.

²⁴⁴ *Ibid.*

²⁴⁵ *Ibid.*

²⁴⁶ *Ibid.*

²⁴⁷ *Ibid.*

All three roles are consistent with profit maximization for shareholders but to differing degrees and time horizons. Each mode has consequences for managerial performance, controlling self-serving and managing the outwards effects of pursuing the profit motive. Viewed on a spectrum of how managers can govern the public corporation, at one end the potential exists for management to take high levels of risk and to focus exclusively on profit maximization while at the other, they can balance profit maximization with other factors such as environmental stewardship. There is no evidence that corporate managers alone wish to expose the environment to high levels of risk and carelessness by taking excessive risks and aggressively pursuing profits.²⁴⁸ In fact, corporate managers in the absence of any incentives or stimuli prefer to play it safe and maintain their reputations as good corporate citizens.²⁴⁹

II. The Effect of Market Forces on Normative Discretion

It is crucial then to recognize how market forces operate in the legal model. Rights of election could enable shareholders not only to discipline a poorly governed Board but also to exert pressure to improve efficiency, risk-taking and profit. However, because the ability to nominate and remove directors is curtailed in practice, an internal market for corporate control is impeded from operating.²⁵⁰ Corporate law strikes a balance between capital and managerial prerogative namely to enable constituents to commit their resources for the long-term. Giving shareholders effective rights to demand greater profit might conflict with long-term corporate organization after a certain point.

The effect of external market forces on operational strategy depends on the liquidity and prevalence of capital markets.²⁵¹ It is also important to realize that historically these forces have differed. In the New Deal period capital market pressures were weak.²⁵² Under deregulation in the Reagan era, they flourished.²⁵³ While this is an oversimplification of the complex factors present at the time, the general trend can be observed. This is evidenced by the wave of corporate

²⁴⁸ Baums and Scott, *supra* note 95, 32-33.

²⁴⁹ *Ibid.*

²⁵⁰ James P. Walsh and James K. Seward, "On the Efficiency of Internal and External Corporate Control Mechanisms" (1990) 15(3)*The Academy of Management Review* 421.

²⁵¹ Hall and Soskice, *supra* note 150; See Gilson, *supra* note 109.

²⁵² Roe, *supra* note 47.

²⁵³ Deakin, *supra* note 7.

takeovers in the 1980's.²⁵⁴ Firms who were under-performing in the capital market were bought-out by corporate raiders through hostile takeover bids.²⁵⁵ These investors would make sometimes drastic changes to how the target company was structured and operated in an effort to find new efficiencies and raise the firm's current market value.²⁵⁶ It has been suggested that such investors would use the hostile bid as a form of arbitrage to extract short-term wealth from the target.²⁵⁷

In response to this frenzy of takeovers, corporate legal scholars theorized into existence the market for corporate control.²⁵⁸ They posited that the threat of being taken over prompted management to run the firm efficiently as possible to keep corporate waste and rent extraction in check, otherwise it would be removed and replaced.²⁵⁹ It is important note that while this market exerts pressure on management's normative discretion, the threat of takeover can be realized only when shareholders have the ultimate right to approve an incumbent hostile bid for the corporation and directors cannot legally block such a sale.

II. The Role of Executive Pay

Normative views on how directors should run the firm pervade the culture of business and finance, translating into certain performance and governance metrics.²⁶⁰ The shareholder value norm underpinned by an elaborately theorized law and economics justification has been influential to this end.²⁶¹ Incentive compensation combined with finance-based metrics has been a powerful tool for shaping managerial conduct.²⁶² As theorists have suggested, the current framework of rules and market forces have supported such arrangements.²⁶³

²⁵⁴ *Ibid.* see also Sciulli, *supra* note 2.

²⁵⁵ See Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (Chicago: University of Chicago Press, 2006).

²⁵⁶ *Ibid.* See also Martin Lipton, "Takeover Bids in the Target's Boardroom" (1979) 35 *Business Lawyer* 104.

²⁵⁷ Deakin *supra* note 7; Lipton, *Ibid.*

²⁵⁸ See Frank H. Easterbrook and Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1982) 94 *Harv. L. Rev.* 1161.

²⁵⁹ *Ibid.*

²⁶⁰ See Jacoby, *supra* note 1.

²⁶¹ See Stout, *supra* note 15.

²⁶² Deakin, *supra* note 7.

²⁶³ See Winter, *supra* note 15; See also Jacoby, *supra* note 1.

III. The Consequences of a Labour-Oriented Executive Pay Norm

Germany's system of Board co-determination provides an example of how labour-oriented pay norms impact corporate constituents and constrains managerial power.²⁶⁴ Both the size of CEO pay and its underlying goals reflect a focus on long-term, stakeholder-inclusive management.²⁶⁵ Shareholder wealth maximization is not the overriding imperative and rent extraction by management is constrained relative to the US approach.²⁶⁶ Co-determination gives labor almost half the seats on the Supervisory Board.²⁶⁷ Share ownership is closely held, enabling capital to monitor the Board more effectively.²⁶⁸ However, shareholder power is not absolute, but balanced against Board discretion.

Having well-functioning rights to appoint the Board, both capital and labour influence directorial discretion through their representatives on the Board. The outcome tends to be a negotiated compromise between labor and capital's competing interests leaving less room for interpreting what valid a business purpose should be.²⁶⁹ The result of this balance is a labour-oriented executive pay norm that entails lower overall compensation and less short-term profit seeking and risk.

Viewed comparatively Germany's corporate governance framework is less tolerant of excessive pay and performance goals which reward short-term profit-seeking.²⁷⁰ While the content and application of Germany's business judgement rule is similar to that of the US,²⁷¹ the scope and substantive impact of its application differ, at least in the area of executive pay. It has been recently settled in Germany, in the *Mannesmann* case, that creating short-term profits is not a valid corporate purpose that can be used to justify large bonus payments to executives.²⁷²

²⁶⁴ Hopt et al., *infra* note 399; See also Baums and Scott, *supra* note 95.

²⁶⁵ *Ibid.*

²⁶⁶ *Ibid.*

²⁶⁷ Gerhard Wirth et al., *infra* note

²⁶⁸ Hall and Soskice, *supra* note 150.

²⁶⁹ *Ibid.*

²⁷⁰ Brigitte Haar, "Executive compensation under German corporate law: reasonableness, managerial incentives and sustainability in order to enhance optimal contracting and to limit managerial power" in Randall S. Thomas and Jennifer G. Hill eds., *Research Handbook on Executive Pay* (Edward Elgar Publishing: UK, 2012) 486-505.

²⁷¹ For a comparison of US and German business judgement rules see Kaal and Painter, *supra* note 135.

²⁷² This is consistent with the German Federal Court's pronouncements in the Mannesmann Trial where it held that short-term profits come secondary to the corporation's long-term interests and that bonuses rewarding short-term profits where the

In *Mannesmann* the German Federal Court elaborated on the permissibility of Anglo-American style pay bonuses rendered for extraordinary gains in shareholder wealth.²⁷³ Despite creating over 50 Billion Euros for the shareholders, the bonuses were deemed excessive because they failed to benefit the corporation.²⁷⁴ Shareholders in this case stood to make an unprecedented short-term gain and were complicit in resisting the awards despite their detriment to the firm itself. Approving the awards in this case represented a conflict between shareholders' and the corporation's interests.

Even in Germany's stakeholder model, where compensation levels are comparatively moderate and coupled with lower-risk strategies, shareholders have the propensity to favour higher levels of compensation in exchange for greater short-term profit.²⁷⁵ On the one hand, this case demonstrates that where the Supervisory Board fails, shareholders also lack the incentive to discipline Boards when they stand to benefit immensely from short-term gains. On the other hand, the response to Mannesmann, illustrates that such orientations are perceived as undermining the labor constituency's interests and the co-determination model's ability to constrain rent-extraction or create a fair distribution of wealth and risk amongst corporate stakeholders.

The period preceding the rise of finance and the shareholder-value norm was marked by lower overall compensation for executives and so-called bureaucratic compensation schemes in public firms.²⁷⁶ This began to change in the 1980's with the deregulation of markets and subsequent rise of incentive pay, culminating in 1990 when the need for high-powered pay incentives was theoretically justified and embraced.²⁷⁷

It was documented by several theorists that high levels of executive pay, albeit not so high by today's standards, were problematic mainly in relation to firm performance.²⁷⁸ In other

corporation does not benefit first and foremost violate directors' fiduciary duties. See Stefan Maier, "A Close Look at the Mannesmann Trial" (2006) 7 *German Law Journal* 603; See also Jobst-Hubertus Bauer, "Boards Beware" (2006) 25(12) *International Financial Law Review* 52.

²⁷³ See Maier, *supra* note 370.

²⁷⁴ For an explicit and detailed narrative of the Mannesmann ordeal see Peter Kolla, "The Mannesmann Trial and the Role of the Courts" (2004) 5 *German Law Journal* 829.

²⁷⁵ Stout, *supra* note 16.

²⁷⁶ Jensen and Murphy, *supra* note 28.

²⁷⁷ Bebchuck and Fried, *supra* note; See also Simon Deakin, *supra* note 3.

²⁷⁸ Jensen and Murphy, *supra* note 28.

words, excessive pay was symptomatic of a larger gap in potential firm growth and wealth creation caused by managerial slack.²⁷⁹ Boards of large public companies, it was said, were sensitive to public pressures to reduce executive compensation which precluded companies from incentivizing top managers to maximize shareholder wealth.²⁸⁰ Stimulating economically stagnant sections of the economy to become more efficient became the focus of executive compensation reform in the LME context.²⁸¹

While it is clear that a labour-oriented pay norm in the US contributes to high levels of managerial slack, it is equally unclear to what extent it can be repudiated and replaced by a shareholder value norm. A certain degree of restraint on both the profit goal underlying CEO pay and its size might be essential to sustainable corporate performance.²⁸² The amount of rent that management could extract before the proliferation of incentive pay, was arguably less than under the current approach. While incentive compensation both in theory and fact stands to create higher firm value, much larger amounts arguably create greater incentives for rent-extraction.

IV. The Consequences of a Shareholder-Oriented Executive Pay Norm

Boards can potentially approve compensation schemes that are connected to a relatively modest set of performance goals that maintain moderate efficiency levels, and a pro-labour management style.²⁸³ Such compensation schemes and their underlying performance goals can enable managers to withhold their maximum efforts, avoid taking risk, and undertake inefficient strategies to safeguard their positions while extracting high levels of pay. This mainly impacts the shareholders. Alternatively, a shareholder value norm impacts non-shareholder groups and creates a counter-effect for how managerial power is constrained.

In the context of industrial capitalism, the debate centred on reducing the size of remuneration and bonuses.²⁸⁴ A financially modest iteration of corporate purpose was valid from an entity perspective and compatible with the existing corporatist labour-capital-state nexus that

²⁷⁹ Lucian Bebchuck and Jesse Fried, "Executive Compensation as an Agency Cost," (2003) 17 *J of Econ Perspectives* 71.

²⁸⁰ See generally, Kevin J. Murphy, "Politics, Economics, and Executive Compensation" (1995) 63 *U Cin L Rev* 713.

²⁸¹ This was the broader impetus behind reforming corporate governance at the time. See Roe, *supra* note 47.

²⁸² See Rappaport, *supra* note 57.

²⁸³ This is what Jensen and Murphy refer to as bureaucratic compensation schemes.

²⁸⁴ An often cited example of excessive compensation in the managerialist context is George Washington Hill of American Tobacco. See Murrey, *supra* note 72.

dominated this period.²⁸⁵ It focused on slow growth, stable operations, and prudent levels of risk-taking which ensured the survival of the enterprise as an institution of the industrial-based political economy, benefiting more than just the stockholders.

In the context of greater market pressures under financial capitalism, whether domestic or transnational, shareholders are purportedly better served by ensuring that high levels of compensation actually reward high levels of performance.²⁸⁶ Thus increasing managerial output is the desirable solution from the standpoint of the shareholder who seeks greater value from the executive's pay check. Several consequences emanate from this.

Shareholder wealth maximization as the overriding imperative to gauge the appropriateness of executive compensation narrows the scope of goals that could otherwise be used to justify rent-extraction. This approach presupposes that the level of executive pay is only justifiable in relation to profit. Yet to earn high levels of profit, appropriate corporate goals need to be set and the CEO remunerated accordingly with the requisite pay arrangements. The more profit produced, the higher the pay arguably deserved.

Holding managerial power accountable exclusively to profit when setting executive pay, shifts shareholders' focus away from the corporation's internal governance and reinforces the parallel role they play as outside constituents who implicitly contract with the corporation to meet their own financial needs.²⁸⁷ This former role benefits all constituents involved with the corporation by enabling shareholders to protect the corporation from harm and ensuring its basic survival. The latter approach begins to separate the interests of shareholders from the well-being of the corporate entity along separate threads. Instead of viewing profit as a product of a successful corporation, this approach views profit as an end in itself and seeks to assess the appropriateness of executive compensation solely in relation to what shareholders gain from the corporation and nothing more.

²⁸⁵ See Bratton and Wachter, *supra* note 45.

²⁸⁶ *Ibid.*

²⁸⁷ P.M. Vasudev and Susan Watson, *Corporate Governance after the Financial Crisis* (Northampton: Edward Elgar, 2012) at Introduction.

Since constraining wealth appropriation and corporate waste in the setting of executive compensation is assessed against profit maximization, shareholders have minimal incentive to control the former if the latter materializes.²⁸⁸ Thus, if an adequate share of the corporation's surplus is being diverted towards satisfying the needs of capital, as they perceive their needs in the context of a competitive market, and away from other groups including the corporation's retained earnings which it uses to plan and invest for the long-term, then capital has a limited concern over how much wealth management actually extracts.²⁸⁹

The challenge with holding the size of the executive's remuneration accountable to the profit motive as opposed to a more moderate articulation of the corporation's best interests is establishing a balance between short-term wealth creation and a longer-term approach to creating sustainable wealth. If the size of the executive's paycheck is of minimal concern to shareholders receiving high rates of return, then what interest would shareholders have in restraining profit-seeking that is overly risky, unsustainable, or damaging to the corporation? The answer to this question is complex and dependent on the risk tolerances of individual shareholders, their level of sophistication as investors, and the quality of information they receive. To propose that capital should assert greater influence on Board decision-making is to assume that shareholders would be able to discern when the profit motive is being overplayed and would be inclined to question the firm's sustainability when current profits are exceptionally high.²⁹⁰ In deeply liquid capital markets selling, diversifying and holding for the short-term are effective risk-mitigation strategies by which shareholders can address these concerns.²⁹¹

Accepting that a threshold exists, past which emphasizing the profit motive undermines the firm's long-term prospects, provided that such a line can be identified, suggests that the size of the executive's maximum potential remuneration should be capped at the point where it corresponds with this threshold. In other words, the maximum potential earnings of the CEO

²⁸⁸ Stout, *supra* note 15.

²⁸⁹ Jacoby refers to this as a coalition between management and capital. It also consistent with the principle-agent model which defines the interests of other constituents as agency costs which must be avoided to achieve shareholder wealth maximization.

²⁹⁰ Even in the too big to fail context, where markets in the presence of accurate information on a financial institution's risk policies for example might discount the value of a currently profitable firm to account for this risk, shareholders lack a strong incentive to compel the Board to change this behaviour. They instead can sell, refrain from buying, or buy at the reduced rate which accurately reflects the inherent risk. If the risk materializes the price they paid accounts for this loss if viewed in the context of a diversified portfolio. What the market fails to account for in this case or prevent in the first place is the economic damage caused to other stakeholders by the failed risk. See Stout, *supra* note 5.

²⁹¹ See Stout, *Ibid.*

cannot be unlimited if after a certain point shareholder wealth maximization begins to harm the corporate entity. Yet, courts have been reluctant to limit executive compensation as long as it corresponds with a valid business purpose.²⁹²

CHAPTER SIX:

The Nexus of Contracts Firm

The nexus of contracts model re-conceptualizes the organizational model of the firm. At the 'structural' level, contractarian orthodoxy proposes to change the structure of shareholder rights by giving shareholders more power. Notwithstanding minor rights, such as the precatory vote on executive pay, contractarians have been largely unsuccessful on this front. At the 'legal' level, contractarians propose that directors' fiduciary duties to the firm, obligate them to maximize shareholder value. As many have argued, there is no basis in law to support this claim. Some contractarians have responded by suggesting that courts should recognize such a duty in 'change of control' transactions and by failing to do so are blocking the disciplining force of the market for corporate control. At the 'normative' level, contractarian orthodoxy has its most serious traction. By justifying shareholder wealth maximization as the principle operating norm, it seeks to approach good governance through the implementation of self-regulating, contractual tools for spurring high performance, namely high powered executive compensation incentives.

In brief, the contractual metaphor defines the corporation and the relationships between corporate actors in narrowly economic terms. It views the corporation as a nexus of contractual relationships entered into voluntarily by shareholders, creditors, managers, employees, customers and suppliers as opposed to a governance structure that contains positions of trust and dependence.²⁹³ Firms are less costly alternatives to market transactions where various parties join their assets in production.²⁹⁴ Corporate relationships and the allocation of rights, benefits

²⁹² See Murrey, *supra* note 72; see also Caywood, *supra* note 72.

²⁹³ For a detailed discussion of the nexus of contracts perspective see John R. Boatright, *Ethics in Finance* (Blackwell, 1999) at 169-198. See also Bratton, *supra* note 47.

²⁹⁴ This view was first posited by influential economist Ronald Coase. See Ronald H. Coase, "The Nature of the Firm" (1937) 4(16) *Economica, New Series* 386.

and risks are determined by the markets in which the firm operates.²⁹⁵ The sole purpose of the corporation is to maximize wealth for the shareholders. Likewise, the aim of corporate governance is to control the agency costs that arise from the implicit delegation of authority from shareholders to management.²⁹⁶ This is justified on three grounds.²⁹⁷ Contractions put faith in market mechanisms to impose constraints on management's tendency to divert wealth from shareholders or to withhold their maximum effort. Due to the contractual nature of corporate relations and the view that forces of competition in markets constrain the private choices of the parties, corporate law is seen as playing an enabling role.²⁹⁸

SECTION A: Shareholder Primacy's Normative Claims

Proponents of the nexus of contracts model and the concomitant norm of shareholder primacy theorize that running the corporation in the interests of shareholders creates maximum societal welfare. The basis for this claim stems from neoclassical economic assumptions best encapsulated as follows:

“A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profit (and jobs). Prosperity for stockholders, workers and communities goes hand in glove with better products for consumers. Other objectives, too, come with profit. Wealthy firms provide better working conditions and clean up their outfalls; high profits produce social wealth that strengthens the demand for cleanliness...wealthy societies purchase much cleaner and healthier environments than do poorer nations-in part because well-to-do citizens want cleaner air and water, and in part because they can afford to pay for it.”²⁹⁹

The alleged triumph of the shareholder primacy model came to a climax in 2000 with the publication of the seminal and heavily disputed article by corporate legal scholars Henry

²⁹⁵ Several scholars have been instrumental in developing the nexus of contracts model. See Easterbrook and Fischel, *supra* note 105; Lucian Arye Bebchuk, “Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law” (1992) 105 *Harv L R* 1435; Bernard S. Black, “Shareholder Passivity Re-examined” (1990) 89 *Mich L R* 520; Victor Brudney, “Corporate Governance, Agency Costs, and the Rhetoric of Contract” (1985) 85 *Colum L Rev* 1403; William L. Cary, “Federalism and Corporate Law: Reflections Upon Delaware” (1974) 83 *Yale L.J.* 663.

²⁹⁶ Agency theory has been well developed to justify this premise. See Eugene F. Fama, “Agency Problems and the Theory of the Firm” (1980) 88 *J. Pol. Econ.* 288; Eugene F. Fama & Michael C. Jensen, “Separation of Ownership and Control” (1983) 26 *J.L. & Econ.* 301; Michael C. Jensen & William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 *J. Fin. Econ.* 305.

²⁹⁷ For an account of these justifications, see John R. Boatright, *supra* note 12. See also William Bratton, *supra* note 18.

²⁹⁸ See Puri et al., *supra* note 18, at 196 (It [corporate law] creates the set of arrangements through which market forces can operate and reduces transaction costs by providing a standard set of default rules.)

²⁹⁹ Easterbrook and Fischel, *supra* note 97.

Hansmann and Reinier Kraakman “The End of History of Corporate Law” also known as the 'end of history claim'. The following excerpt reflects the crux of the claim:

“Despite the apparent divergence in institutions of governance, share ownership, capital markets, and business culture across developed economies, the basic law of the corporate form has already achieved a high degree of uniformity, and continued convergence is likely. A principal reason for convergence is a widespread normative consensus that corporate managers should act exclusively in the economic interests of shareholders, including non-controlling shareholders. This consensus on a shareholder-oriented model of the corporation results in part from the failure of alternative models of the corporation...Other reasons for the new consensus include the competitive success of contemporary British and American firms, the growing influence worldwide of the academic disciplines of economics and finance, the diffusion of share ownership in developed countries, and the emergence of active shareholder representatives and interest groups in major jurisdictions. Since the dominant corporate ideology of shareholder primacy is unlikely to be undone, its success represents the "end of history" for corporate law.”³⁰⁰

SECTION B: Shareholder Primacy's Internal Conflict: The Case of Takeovers

The shareholder primacy model's internal conflict is manifest in the hostile takeover debate over the correct role of law in either protecting or constraining directors' discretion to resist a hostile bid. It divides contractarians essentially into two camps, shareholder-rights and director-primacy contractarians. These viewpoints in turn underpin competing accounts of the executive compensation issue in the nexus-of-contracts paradigm, the managerial power and optimal contracting approaches respectively.

I. The Contractarian Justification for Takeovers

The nexus of contracts model began to emerge in the late 1970's to explain and legitimate the wave of corporate takeovers that began to sweep across the U.S. corporate world. Law and economics scholars embraced this newly emerging form of capital market activity as the disciplining function of efficient markets against managerial slack and the rents of corporate control.³⁰¹

Efficient capital markets coupled with effective disclosure rules in theory signaled to investors the presence of high agency costs which would prompt them to purchase control of the firm at what they perceived to be a bargain. This strategy, made possible by a competitive market

³⁰⁰ Hansmann and Kraakman, *supra* note 154.

³⁰¹ Frank H. Easterbrook & Daniel R. Fischel, “The Proper Role of a Target's Management in Responding to a Tender Offer” (1981) 94 *Harv. L. Rev.* 1161; Ronald J. Gilson & Reinier Kraakman, “Reinventing the Outside Director: An Agenda for Institutional Investors” (1991) 43 *Stan. L. Rev.* 863; Henry G. Manne, “Mergers and the Market for Corporate Control” (1965) 73 *J. Pol. Econ.* 110.

for capital, provided a solution for the various difficulties that shareholders faced in monitoring, replacing or disciplining directors who failed to reduce agency costs in the firm.³⁰²

II. The Politics of Discretion: Stakeholder Statutes

In response to the wave of takeovers that swept the US business world in the 1980s, several states enacted stakeholder statutes as a means of strengthening directors' ability to resist hostile bids and to mitigate the harmful outwards effects of hostile takeovers.³⁰³ Given that such transactions were feasible in the current framework of directors' discretion, Boards were able to block takeover bids for their firms, allowing them to protect their positions, despite generating agency costs.³⁰⁴ The divide in contractarian thinking in the takeover context is underpinned by two competing theories discussed for blocking hostile bids. These in turn can be situated into broader theoretical frameworks that represent a fundamental disagreement over the role of directorial discretion in corporate governance and the efficacy of market forces.

This engendered conflict between capital and incumbent Boards, the former of which would often allege that directors were in breach of their fiduciary duties. An early debate emerged on whether the existing level of discretion under the 'business judgment' rule represents an optimal and enduring arrangement produced by the market or whether it constitutes an arrangement which interferes with how the market functions.³⁰⁵ The key issue was whether corporate judiciaries should uphold a legal duty to maximize shareholder wealth in the takeover context or whether discretion to pursue the long-term best interests of the corporation should be protected.³⁰⁶

III. Shareholder Rights Contractarians

A core premise of this perspective is that legally protected discretion amounts to State and judicial interference in the market for corporate control which leads to weak constraints on managerial power. Alternatively, allowing the market for corporate control to operate unimpeded

³⁰² See Manne, *Ibid.*

³⁰³ See Anthony Bisconti, "The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?" (2009) 46 *Loyola L.R.*

³⁰⁴ Roberta Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" (1992) 9 *Yale Journal on Regulation* 119.

³⁰⁵ See Easterbrook and Fischel, *supra* note 301.

³⁰⁶ *Ibid.*

would control agency costs and lead to optimal arrangements between shareholders and management. Shareholder rights advocates propose several changes to increase shareholder power, their most pressing agenda is to 'unfetter' the market for corporate control. Arguing that shareholders should be able to exercise undistorted choice when faced with a takeover bid, Professor Bebchuk advocates for legal limits on takeover defenses.³⁰⁷ When a takeover bid is made against a firm, management's and shareholders' interests sharply diverge, as directors' independence is threatened.³⁰⁸

IV. Director Primacy Contractarians

A core premise of this perspective is that the current configuration of corporate law, including legally protected discretion is an optimal outcome of market forces. State and judicial protection of directorial discretion to block a hostile bid stems from self-imposed limitations on the market for corporate control. While the end governance goal is shareholder wealth maximization, existing market forces and legal arrangements are said to be ideal for achieving the requisite norms of directorial conduct for achieving this end.³⁰⁹

SECTION C: The Outcome of Existing Market Forces

Gordon Smith argues that the shareholder value norm remains the operative decision-rule for managing the firm, due to market forces, despite uncertainty whether a legal duty to maximize profits exists. Smith's fundamental position is that “changes in corporate law cannot eradicate poverty or materially change existing distributions of wealth, except by impairing the creation of wealth” and that changes in corporate law that will have an effect on labor inequality and the environment will make things worse not better.³¹⁰ In effect he argues that the claims

³⁰⁷ Lucian Ayre Bebchuk, “The Case Against Board Veto in Corporate Takeovers” (2002) *69 U Chi L R* 973.

³⁰⁸ *Ibid.* (Ex ante agency costs arise where Board veto power is present, as the Board experiences greater security from the threat of takeover and will tolerate greater levels of slack. Despite arguments in favor of veto power, that takeovers negatively impact long-term shareholder value, aggregate shareholder wealth and the well-being of stakeholders, Bebchuk argues that when Boards exercise veto to block a bid, target shareholders lose in the long-term as well as in the short-term. Moreover, if the wealth of the bidder and the target are taken into account, Board veto which extracts a higher premium is merely a transfer of wealth from bidder to target. In cases where the takeover is successfully blocked, the bidder is denied from an otherwise profitable acquisition.)

³⁰⁹ Stephen M. Bainbridge, “Director Primacy” *UCLA School of Law-Law-Econ Research Paper No.10-06* (25 May 2010) Online: SSRN, <<http://ssrn.com/abstract=1615838>>.

³¹⁰ Kent Greenfield and Gordon D. Smith, “Debate: Saving the World with Corporate Law?” *Boston College Law School Faculty Papers, Paper 198* (2007), Online: <http://lawdigitalcommons.bc.edu/lspf/198>.

made by progressive corporate law scholars that changing corporate decision-making by either changing the structure of the Board or the shareholder value norm will not improve aggregate social wealth. More specifically, Smith argues that changing the composition of the Board to include stakeholder interests “would not significantly change the profit-maximizing orientation of those firms” due to the power of product, capital, and managerial labor markets which “severely constrain the options available to managers”.³¹¹

Smith argues that existing Board structures persist because Boards recognize that the current structure and the discretion it affords to directors to pursue efficiency and profit-maximization as the corporation’s predominant goal, are what ultimately makes sense for shareholders because it yields the most value and the best use of the corporation’s productive capacity. Smith addresses the assertion made by Greenfield and other scholars that corporate law should not prevent directors from taking into account the societal interests that the corporation is ultimately meant to serve.³¹² He argues that such a statement is actually irrelevant because the shareholder primacy norm in corporate law “is both unenforced and unenforceable” meaning that it is not an outcome of the law but of markets.

I. Team Production Theory

Lynn Stout and Margaret Blair advance Team Production Theory (“TPT”) which is ultimately rooted in the nexus-of-contracts model of the firm. Like the above claim, it posits that the rules governing corporate actors, namely Board power and discretion is an efficient outcome of market forces.³¹³ However, TPT departs somewhat from shareholder primacy's core concepts.

TPT rejects the principle-agent theory of shareholder-management relations and posits the Board of Directors as a mediating hierarchy with shareholders necessarily having limited power over corporate decisions.³¹⁴ TPT claims that economic organization often requires the combined investment and coordinated effort of multiple groups.³¹⁵ If these inputs are firm specific and cannot be separated from the collective enterprise, serious problems arise with how to divide-up the economic surpluses generated, especially where the corporation's activities and

³¹¹ Smith, *Ibid.*

³¹² Greenfield, *Ibid* at 965.

³¹³ Blair and Stout, *supra* note 194.

³¹⁴ *Ibid.*

³¹⁵ *Ibid.*

environment are highly dynamic and complex.³¹⁶ Preset rules guaranteeing claims encourage parties to reduce optimal efforts.³¹⁷ Attempts to divide surpluses during production, create opportunities for rent-extraction by managers, shareholders or labor.³¹⁸

Corporate law is an institutional substitute for explicit contracting. Parties opt into a governance structure, what Blair and Stout call, a mediating hierarchy, giving up property rights over their inputs and the venture's joint outputs to the corporate entity. A key function played by corporate law is to ensure the Board's independence from team members. Shareholders are given voting and legal rights only to discipline ineffective Board governance. TPT fundamentally differs from the organizational model in that it rejects the imposition of mandatory norms of behavior onto the Board that are shareholder or stakeholder based.³¹⁹

The most intriguing part of TPT is that it recognizes the effects of political forces on management orientation, coalition formation in the firm, and on how the Board allocates resources and risk between stakeholders.³²⁰ Implicitly it recognizes a nexus between politics and market forces and attempts to explain why management orientation before the 1980s favored labor in the US. They suggest that shifting market and political forces in the 1980s re-configured the extent to which the Board considered shareholders' interests over those of labor, resulting in the current framework of director primacy. While they posit that director primacy has persevered due to the efficiency and optimality of this arrangement, they recognize a wide range of possibilities for how the firm can be run.

SECTION D: Shareholder Primacy's External Conflict

Outside the nexus-of-contracts paradigm, State and judicial protection of directorial discretion can also be viewed as regulation against the outwards negative effects of the market for corporate control. Accepting that takeovers create efficiency and shareholder value, this view recognizes that such forces simultaneously impact societal welfare in a negative way. Rejecting

³¹⁶ *Ibid.*

³¹⁷ *Ibid.*

³¹⁸ *Ibid.*

³¹⁹ For a discussion of mandatory norms see Gordon, *supra* note 39.

³²⁰ Blair, *supra* note 196 at 320-328.

shareholder primacy's normative claims that profit-seeking maximizes net societal welfare this perspective views the effects of capital market expansion as undermining the well-being of the firm's non-shareholder constituent groups.

Proponents of both director primacy and shareholder rights models periodically engage with the normative claims made under this perspective. A well-known exchange between Gordon Smith and Kent Greenfield accurately characterizes this debate. Greenfield employs an organizational/regulatory view to argue that other stakeholders such as creditors and employees should have legal rights in corporate law in some capacity.³²¹ Greenfield's view can be distilled to two general proposals to change corporate law. One is to change the decision rule which currently guides managerial conduct. The other is to change the decision-maker or at least re-configure the existing framework of decision-makers to include stakeholders' voice.

Greenfield focuses on the pervasive effects of corporate power on society which he refers to as "breaches of the public trust or the imposition of costly externalities on stakeholders or communities."³²² Greenfield's concern is that "as globalization intensifies, the narrow shareholder/executive focus of U.S. corporate law is increasingly exported, displacing the more expansive, public-oriented view of corporations in other nations."³²³ He argues that the divide between internal shareholder and external stakeholder regulation is misguided and that non-shareholder interests are better protected by internal rules governing managerial conduct.³²⁴

SECTION E: Executive Pay from a Contractual Perspective

When applied to executive compensation, the contractual metaphor shifts the interests of shareholders to the forefront, misaligning their interests from the corporate entity. It focuses on the relationship between shareholders and management and problematizes managerial power as agency costs, defined as a failure of managers to pursue only strategies that maximize shareholder value. At the Board level, this translates into a failure of directors to ensure that

³²¹ Greenfield, *supra* note 310.

³²² *Ibid*; See E. Merrick Dodd, Jr., For Whom are Corporate Managers Trustees?, 45 HARV. L. REV. 1145, 1152 (1932); A.A. Berle, Jr., For Whom Corporate Managers Are Trustees: A Note, 45 HARV. L. REV. 1365, 1367 (1932).

³²³ See Greenfield, *Ibid* at 2 (citing Lawrence Mitchell, Corporate Irresponsibility, America's Newest Export (2003)).

³²⁴ Greenfield, *Ibid*.

managers adhere to shareholder interests alone. This suppresses the relevance of other interests to overall corporate performance and precludes governance orientations that serve a balancing function, justifying the shareholder value norm.

I. Why Bureaucratic Compensation Schemes?

Contractarians claim that corporate governance was previously ineffective due to pressures from labor and pro-social groups to reduce the size of executive compensation. This resulted in bureaucratic compensation schemes which failed to reward high levels of profit-maximization. This gives rise to a puzzling question, if market forces lead to optimal outcomes, then why did such schemes pervade the corporate landscape before the 1990's? Contractarians explain that a lack of takeover activity previous to this model's emergence is attributable to a legal framework highly supportive of protections and benefits for labor, which interfered with optimal market outcomes. Moreover, market pressures were previously weak and allowed for managerial slack, making it easier for labor to influence management orientation. In corporate governance, the underlying paradigm shift that needed to occur was for directors to understand their role as agents of the shareholders and to set compensation schemes that would compel efficiency, greater levels of risk, and profit-seeking.

II. Why Is Executive Pay Still A Problem?

The optimal contracting and managerial power approaches previously addressed, represent competing views within the contractarian model over why this model fails to create good corporate governance through efficiency, high performance and maximum profits. These approaches can be overlaid onto the competing assertions of director versus shareholder primacy theorists.

The optimal contracting approach is supported by director primacy's claim that the current balance of power between shareholders and management and the existing level of directorial discretion do not interfere prohibitively with how markets function.³²⁵ Current market forces exert adequate pressure on directors to focus on shareholder value maximization and to create optimal pay incentives between executives and the corporation. In other words, notwithstanding inadequacies in design and best practice, there is no fundamental problem with

³²⁵

For a concise yet detailed explanation of this theory see Bebchuk and Fried, *supra* note 94.

compensation contracts from a director primacy perspective. Proponents of optimal contracting attribute the role that incentive compensation played in the short-sighted management and excessive risk-taking that contributed to the crisis to perverse incentives. The potential role of capital markets and myopic investors in precipitating perverse incentives is not acknowledged by this approach. Instead, optimal contracting theorists view the solution as better incentive structures and practices that more closely align shareholders' and management's interest without canvassing the possibility that many short-term investors might be satisfied with extracting short-term wealth at the corporation's long-term expense.

The managerial power approach is supported by the claims of shareholder rights theorists that corporate law, namely the business judgment rule and the current balance of power between shareholders and the Board interferes with the disciplinary force of the market.³²⁶ Despite the liberalization of markets that occurred in the 1980s, corporate law needs further reform to ensure that corporate takeovers occur without regulatory and judicial interference. The result is weak market forces which fail to exert pressure onto Boards to serve shareholders' interests by creating optimal performance incentives and controlling rent extraction. Executives exert counter-pressure onto directors, permitting them to extract excessive levels pay and undermine incentives designed to constrain their own behavior.

SECTION F: An Alternative Approach to Conceptualizing the Executive Pay Problem?

A third possible approach posits that if markets do exert significant pressure as the optimal contracting model suggests than the advent of these forces are responsible for the current phenomena of short-term behavior and excessive risk. Incentive compensation in fact does work as intended and effectively ties managerial behavior directly to the capital market. Being highly responsive to market forces managers exploit fundamental flaws in this market model.

The combination of significantly higher levels of pay and market forces prompt managers

³²⁶

Ibid.

to extract greater levels of rent while necessarily satisfying market demands. Thus, high powered incentive pay creates two sets of conflicting incentives. One, to create results in share price and two, to extract high amounts of rent. This is more a product of tying performance incentives to the capital market than a result of flawed design. In contrast, where market pressures are weak, the easier alternative is for executives to bargain for generous pay and take less risk, exert less effort, or engage in empire building. The fact that managers actually pursue short-term gains indicates that market pressures do significantly influence managerial conduct. This approach be summarized as follows:

In order to maximize his personal wealth, the executive has a perverse incentive to focus on only those programs and factors most closely affecting the amount of his compensation. Since his compensation depends on the company's performance, and the company's performance is measured primarily by earnings-per-share or market price, the executive has incentive to do whatever is necessary to prop up this quarter's earnings or increase the market price of shares. Instead of positioning the company for the future, which is an important objective of the the executive's attention is diverted to positioning the company to meet short-term goals.”³²⁷

Unlike the managerial power theory, which holds that managers weaken the terms which bind them to perform optimally, this approach posits that managers do not manipulate their pay incentives to bind themselves to excessive risk-taking and extreme short-term strategies. This is better explained by powerful market forces and a pervasive shareholder value norm which compel directors to develop incentives which succeed in compelling executives to raise share price and take-on more risk.

While incentive compensation purports to solve the performance issue, it fails to address and potentially worsens other aspects of managerial power. Furthermore, it conflates differing aspects of managerial power, such as rent extraction and the outwards effects of risk-taking, with a lack of adequate performance. In sum, this third approach posits that the current outcome of market forces, short-sighted management and excessive risk-taking, is an inherent flaw of the market-based governance approach itself stemming from an over-reliance on efficiency and profit-based governance norms. The proposed solution then would be to introduce long-term

³²⁷

Ibid at 68.

oriented norms of conduct for Boards to follow when setting executive pay to counter short-term orientations. This could include limiting the size of maximum compensation payable to insulate executives from myopic market forces.

PART III- Can Shareholder Primacy Accommodate Sustainable Long-Term Governance?

CHAPTER SEVEN:

The Executive Compensation Debate as Competing Theories of the Firm

These distinct perspectives of corporate law's role are simultaneously instantiated in corporate legal statutes.³²⁸ They are also reflected in the corporate judiciary's treatment of corporate governance disputes which at certain times can be viewed as facilitating contracting while at others as imposing mandatory norms.³²⁹ However, since its rise in the late 1970's the presence of law and economics thinking in corporate law has increasingly challenged established corporate law doctrine.³³⁰ By rejecting the imposition of behavioral norms in favor of market-based solutions to a narrowly defined principle-agent problem between shareholders and management, the contractual view advocates for a 'laissez-faire' approach to corporate governance that suppresses the relevance of the entity metaphor under which the interests of non-shareholder constituents can be accounted for.³³¹

Where the contractual approach attempts to prevail is the limitation it places on management's normative discretion to consider interests other than shareholder wealth maximization in the context of running the firm. Yet, up to a certain point, it is not necessary for this prerogative to conflict with what corporate law attempts to achieve in terms of defining and imposing appropriate norms of conduct. However, we have reached a point at which we now stand in the post-crisis debate over executive compensation which has demonstrated that this

³²⁸ See Puri et al., *supra* note 196.

³²⁹ Corporate legal statutes in the U.S. and Canada contain rules that establish non-negotiable terms for those choosing to adopt the corporate form while also providing "standard form contractual terms". For a discussion of the CBCA, see, Puri *supra* note 207. While some of these rules have proven to be ambiguous, the lines between what is mandatory and what can be contracted around have been established over time by courts. See *Bushell v. Faith*, [1970] A.C. 1099, [1970] 1 All E.R. 53 (H.L.) and *Kelly v. Electrical Construction Co.*, 1907 CarswellOnt 248, 16 O.L.R. 232 (Ont. C.P.).

³³⁰ For a detailed discussion of the influence of law and economics thinking on corporate law and the tensions that exist between this view and previously established corporate law doctrine, see generally David Sciulli, *supra* note 2. See also William Bratton, *supra* note 104.

³³¹ It does this directly by including in its definition of agency costs the consideration of non-shareholder interests. Because this approach posits the market price of a firm as an accurate proxy for how well agency costs are controlled, actions taken to convey benefits onto stakeholders as part of a long-term strategy to create sustainable returns might signal the presence of agency costs because they lower current profitability.

prerogative has gone too far. The quest for higher performance has exacerbated managerial power and has significantly undermined the function that corporate law plays in protecting the corporation from damage at the hands of its management.

Not only is this reflected in the post-crisis theoretical debate over the shareholder primacy norm that has since ensued, but it is central to the debate over executive compensation reform which to a large extent has failed to acknowledge the significance of this conflict for the optimal contracting paradigm from which compensation reform is being approached. As the dominant approach to solving the managerial power problem in the firm, incentive compensation arguably has succeeded in displacing the entity model, thus weakening its mitigating function between the competing demands of capital and labor markets. While this approach of enabling capital and product markets to discipline managers was the inevitable consequence of the corporatist legacy, the important question raised is whether it addresses the full extent of managerial power in the firm or whether it provides further opportunities for managers to appropriate wealth by overemphasizing the profit motive and transmitting risk to other stakeholders?

While strong product and capital are inevitable results of the LME framework's historical development, the danger lies in allowing managers to advance shareholder interests in the interim, past the point where it begins to harm the corporate entity. There needs to be a mechanism for reconciling the competing demands of these market forces with the interests of other groups to achieve an overall level of stability in the political economy. While the previous solution has attempted to achieve this end by allowing for some level of agency costs, placing limits in effect on profit maximization, the current dilemma for achieving an appropriate discretionary balance is between increasing shareholder rights or accepting a 'director primacy' model of the firm. Questions arise whether either model results in sustainable governance and management practices.

SECTION A: What Would Increasing Shareholder Power Result In?

A relevant line of inquiry in the post-crisis context is whether the existing structure of corporate law conforms to a shareholder or director-centric model of governance. While this debate is academic, it underpins a normative debate on whether the current balance of power between capital and management should be maintained.

I. Theories of Director Governance

Professor Lynn Stout poses a challenge to the existing presumption that the shareholder primacy model best explains corporate law. She argues that “shareholders do not have ultimate control over directors, directors do not always seek to maximize share price [and that] the rights granted to shareholders are limited in scope and they do not enable shareholders, as a matter of law or fact, to insist that managers act as their agents serving only their interests.”³³² She further asserts that promoters of companies will often seek to weaken shareholder powers and that shareholders do not object.³³³ While the thrust of Stout’s argument is to assess whether corporate law and the corporation’s structure is consistent in actuality with the shareholder model, she also lays out several theoretical arguments against shareholder primacy as a basis for corporate governance reform.

The most relevant is the ‘Market Inefficiency and Director Primacy’ model. This view highlights the weakness of agency theory’s assertion that efficient markets price a company’s stock accurately so that it accounts for future risks and returns. Emerging literature points to the fact that stock prices diverge from real value creating the opportunity for strategies to boost value in the short-term but harm the firm in the long-term.³³⁴ This theory holds that all shareholders are better off to give control to a Board so that it can run the company for the benefit of long-term stakeholders.³³⁵ Thus, reforming corporate governance should not entail further reliance on capital markets but on stronger directorial decision-making and arguably on clearer norms of conduct.

³³² Lynn Stout, *supra* note 16.

³³³ *Ibid.*

³³⁴ See Peter Boettke, “What Happened to “Efficient Markets”? 14 *The Independent Review* 363.

³³⁵ See William W. Bratton and Michael L. Wachter, “The Case Against Shareholder Empowerment” (2010) 158 *U of Penn LR* 653.

II. The Merits of Shifting Power to Shareholders

Professor Bainbridge argues that increasing shareholder involvement in corporate decisions can disrupt the mechanisms that make the public corporation feasible, the vesting of authority in the Board of Directors.³³⁶ He cites that such a model is based on an organizational model of decision-making premised on consensus and authority.³³⁷ Consensus is employed when voting stakeholders in a firm have similar interests and information and occurs at low cost while authority is exercised by the Board when the interests of voting stakeholders conflict and information is uneven. The Board balances interests in a manner consistent with the organization's interests as a whole and stakeholders must live with this compromise, as it's the most efficient.

III. "Ten Ways to Create Shareholder Value"

In response to the claim that increasing shareholder rights will increase shareholder value, the work of Alfred Rappaport suggests many firms sacrifice sustained growth for short-term gain to satisfy short-term earnings expectations. He cites that 80% of executives would sacrifice critical R & D spending to bolster quarterly earnings, limiting opportunity to create enduring value for shareholders. He identifies 10 principles that firms can follow to create lasting value:

- 1) Do not manage earnings or provide earnings guidance;
- 2) Make strategic decisions that maximize expected value, even at the expense of near-term earnings;
- 3) Make acquisitions that maximize expected value, even at the expense of near-term earnings;
- 4) Carry only assets that maximize value;
- 5) Return cash to shareholder when there are no credible value-creating opportunities to invest in the business;
- 6) Reward CEOs and other senior executives for delivering superior long-term results;
- 7) Reward operating-unit executives for adding superior multi-year value;
- 8) Rewards middle managers and front-line employees for delivering superior performance on the key value drivers that they influence directly;

³³⁶ Stephen M. Bainbridge, "Remarks on Say on Pay: An Unjustified Incursion on Director Authority" (4 March 2008) *UCLA School of Law, Law & Economics Research Paper Series, Research Paper No. 08-0*.

³³⁷ Bainbridge, *Ibid.* (citing Kenneth J. Arrow, "The Limits of Organization" (1974) 68-70).

- 9) Require senior executives to bear the risks of ownership just as shareholders do;
- 10) Provide investors with value-relevant information.

In sum, these principles are underpinned by a strong claim that director primacy is necessary to allow Boards to implement lasting long-term sustainable performance. Shareholders themselves lack an incentive to sacrifice short-term gains in the manner described. Thus, incentive contracts which tie shareholder expectations directly to management strategies preclude managers from implementing long-term strategies. Reliance on incentive contracts by Boards displaces the exercise of discretion to create long-term shareholder value.

However, the case against increasing shareholder power advanced by director primacy theorists fails to assess whether the manner in which directors currently balance the interests of voting versus non-voting stakeholders in the presence of existing market forces leads to sustainable wealth creation. If directors succumb to short-term pressures and implement policies which tie shareholders' myopic expectations directly to managerial decision-making, can existing compensation arrangements be said to be optimal? Bainbridge seems to suggest that overall current arrangements are optimal. However, these are not entirely consistent with Rappaport's principles for creating shareholder value.

SECTION B: What Arrangements Do Existing Market Forces Lead To?

The key question then is what director primacy actually looks like in practice and how recent events surrounding the crisis and executive pay should be explained. Is rejecting greater shareholder control in favour of allowing Boards to retain their discretion suitable for constraining short-term behaviour, excessive risk-taking and the outwards effects of corporate power? The claim of E. Merrick Dodd in the post-Depression context is essentially the claim of director primacy theorists today. However the effects of existing market forces on management orientation need to be better accounted for.

I. The Politics of Finance

The politics of finance literature offers an explanation for why and how the shareholder primacy model is unsustainable. Being rooted in political economy, it overlaps with newly

emerging corporate legal theory that challenges shareholder primacy. Its key contributions are that it alternatively explains what drives the market and what the prospects are for market based governance norms.³³⁸ Written after the financial crisis, the work of Sanford Jacoby on finance and labor is concerned more generally with examining patterns of economic development and crises on the one hand and financial inequality and the distribution of economic risk in society on the other to explain how corporate governance might be changing in response to the latest financial crisis. In particular the literature seeks to explain the increased economic and political significance of finance and the shift that most developed countries have made away from “industrial capitalism” towards “financial capitalism” and how it might be changing in the post-crisis period. The changes associated with this shift that he refers to as financial development pertain mostly to how business corporations are operated and governed. They include, the expansion and fluctuation of capital markets since the 1980’s; the rise in finance-derived incomes and occupations; the increasing role of corporations as short-term investment vehicles and; the dominant influence of shareholders over corporate decision making and executive pay.

The literature also seeks to explain the concomitant rises in income inequality, employment risk, wage and employment volatility, and the shifting of responsibility to employees for pensions that have also occurred since the 1980’s and whether they have any relationship to this process of financial development and the changes that have occurred in corporate governance. In attempting to account for and explain these changes it explores the relationship between a rise in financial capitalism and levels of income and risk inequality. In doing so it challenges the dominant view of 'economic liberalism' that purports to explain these phenomena as a natural expansion of the self-regulating market. In particular it focuses on the corporate governance aspects of these phenomena by examining the relationship between how business corporations are governed and why swings in financial development and inequality occur. Its premise directly challenges not only the law and economics assertion that markets can adequately regulate corporate agents but also the view put forth by contractarians that the solutions to reforming corporate governance to avoid or mitigate future crises lie in bolstering how these liberal market mechanisms work.

³³⁸ For a detailed explanation of the 'Politics of Finance' see Jacoby, *supra* note 1.

The crux of the argument is that the past and current trajectory of economic development and patterns of crises can be explained as a political contest between those who drive and benefit from financial development and those who experience income and risk inequality. The prominence and decline of finance and financial interests over the last century and the rise and fall of inequality are interrelated by cause and effect and are driven by a political process. This is referred to as “the politics of finance” which holds that the economic changes since the 1980’s can be explained as a prominent period for finance which creates a rise in inequality and risk. Elite beneficiaries of finance exert political pressure on governments and regulators to develop policies that favor the expansion of finance and the establishment of the unregulated or “self-regulating market”. This is evidenced by corporate governance arrangements that emphasize short-term returns for shareholders, executive pay incentives aimed at creating short-term value, self-regulatory governance arrangements such as stock options aimed at aligning shareholder and manager interests and much of the corporate takeover activity in the 1980’s which resulted in firms being used as short-term investment vehicles and arbitrage.

This in turn causes wealth to flow to top income groups in the form of increased investment gains and finance-based incomes such as executive pay. At the same time a wide coalition of groups in the lower income brackets such as workers and sometimes middle class income earners exert political pressure to resist financial expansion and sometimes succeed in causing finance to contract. This is evidenced by labor union activity and the prevalence of institutions aimed at smoothing inequality and risk such as pension schemes and employer funded safety nets for employment and health risk.

To politics of finance premise is founded on the work of Karl Polanyi written in the 1940’s about a phenomenon called the “Double Movement” which provides the underlying theory for the relationship between financial expansion and inequality.³³⁹ Accordingly Polanyi’s theory challenges the economic liberalism paradigm by showing that the expansion of the “free” and “self-regulating” market is actually embedded in the politics and culture of a society and that markets themselves are ineffective at correcting the negative effects of market expansion. As market expansion intensifies, counter-movements against market expansion erupt to resist these negative effects. Elites in society aim to establish an unregulated market that operates in their

³³⁹ Polanyi, *supra* note 22.

favor until that particular market reaches a turning point signaled by a crisis or failure at which its negative effects are the most intense. This is usually followed by a movement to contain the market failure and establish a new economic order which better protects society.

The politics of financial development view not only applies to contests that happen in policy arenas but inside the corporation as well. Within corporations there is a contest over the allocation of a corporation's surplus or "value-added" between shareholders, executives, workers and the corporation's retained earnings. Corporate governance arrangements affect this distribution. Different actors within the corporation over time have been arranged into different factions. The historical arrangement of these factions within the firm is consistent with and explains the swings in financial development and inequality over the last century. The period before the Great Depression was characteristic of a coalition of shareholders and executives against worker interests. Consequently, income and risk inequality for workers was increasing up until the crisis in 1929. After this period, there was a progressive shift towards the alignment of executive and worker interests against shareholders, which saw significant improvements in income inequality and the establishment of mechanisms to smooth and mitigate the wage and unemployment risks faced by employees. This arrangement continued until 1980 which marked a turning point at which shareholder interests started to become aligned with executives against the interests of workers due to the deregulation of policies that supported wealth distributing and risk smoothing mechanisms. The period since 1980 saw an unprecedented rise in financial development which has come to an end with the financial crisis.

A key premise of the liberal market claim is that the alignment of executive and shareholder interests requires self-regulating market mechanisms. Managerial power is held in check through the self-interest and greed of shareholders. The politics of finance demonstrates that profit seeking as a means of holding managers accountable damages the long-term prospects of the firm in which employees, communities, and the public have a long-term interest. In other words the self-regulating market as a governance mechanism is prone to failure because it allows some constituents to extract significant wealth from the corporation at the corporation's expense which damages other interests in the process. This challenges the view that inadequate adherence to shareholder interests leads to breakdowns in corporate governance and also that existing market forces lead to optimal outcomes.

II. Post-Crisis Assessments of the Market's Governance Prospects

The post-crisis debate over corporate governance amongst leading corporate law scholars engages with the debate in corporate law “over whether directors should consider the interests of shareholders only or a wider constituency of stakeholders that includes groups such as consumers”.³⁴⁰ While this question is at the heart of the matter, the consequences of how this question is answered relate directly to the question of what types of economic arrangements put the corporation’s productive resources to their best use; ensure that those who exercise power and control over deploying these resources do so in a responsible manner; and enhance our aggregate social welfare. Written in the context of the financial crisis where we saw the near demise of long-standing financial institutions, this debate questions some the key tenets that underpin our current economic systems. It calls into question our current approach to the social control of economic life, the self-regulating market, and our understanding of what the business corporation is. Several of the scholars who engage with this debate respond directly to Hansmann and Kraakman’s “End of History of Corporate Law” claim which asserted in 2001 that shareholder primacy was the dominant uncontested form of economic ordering.³⁴¹

One line of inquiry advanced by Professor David Millon, looks at the shareholder primacy model more in terms of how the corporation is run as a matter of governance. It focuses on the interplay between corporate law and how the corporation is run and also on the non-legal factors that shape corporate behavior. It provides a basis for proposing how the corporation should be run as a matter of practice, which governance theory provides a better working model, and whether the practice of shareholder primacy, defined here as running the corporation in shareholders’ short-term interests, is changing. Millon assesses whether a shift is occurring in the post-crisis period away from shareholder primacy towards a model called Enlightened Shareholder Value which holds that “the corporation should pursue shareholder wealth with a long-run orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests”.³⁴² His main argument is “risk management practices are helping in reinterpreting the corporate goal and in promoting the consideration of

³⁴⁰ See Vasudev and Watson, *supra* note 17.

³⁴¹ See Hansmann and Kraakman, *supra* note 158.

³⁴² David Millon, *supra* note 17.

stakeholder interests in ways that resonate with notions of corporate social responsibility”.³⁴³ He asserts as a testable hypothesis that market forces are exerting pressure onto business to shift away from myopic labor and environmental tendencies because of the realization that these practices carry significant risk. He concludes that market forces are currently not oriented towards affecting a significant shift towards ESV and legislation and corporate law must therefore play a role in influencing corporate behavior.

Another line of inquiry advanced by Professor Leonard I. Rotman, focuses more heavily on assessing the efficacy of the shareholder primacy norm as an underlying basis for corporate governance. This view looks more at shareholder primacy’s track record, its impact on social wealth, and its effectiveness in constraining managerial power and whether corporate governance should continue to rely on the shareholder primacy norm or embrace a longer-term more stakeholder-inclusive view to managing the corporation. Rotman argues that the two major corporate law cases that shareholder primacy theorists rely upon to make their case, *Dodge v Ford Motor Co* (1919) and *Revlon Inc v MacAndrews & Forbes Holdings Inc* (1986) do not in fact establish a shareholder primacy norm and are more consistent with a stakeholder inclusive view of governance. From this he concludes that the foundational corporate law issues of corporate identity (what is the corporation in law?) and corporate purpose (who should the corporation be run for?) are not resolved as Professors Henry Hansmann and Reinier Kraakman suggested a decade earlier. He addresses some flaws he sees in the shareholder primacy model, namely that “shareholder primacy unduly skews the focus of corporate directors” and refers to Enron and the recent financial crisis as examples of how “market pressures and managerial incentives cause unwarranted risk-taking that benefits management and shareholders in the short-term, but may ultimately lead to the demise of the corporation.”³⁴⁴

³⁴³ *Ibid.*

³⁴⁴ See Rotman, *supra* note 21.

SECTION C: To What Extent Can Directors Consider the Interests of Other Stakeholders?

Both director and shareholder primacy contractarians argue that market forces lead, or could lead if unfettered, to optimal management orientations. The extreme view, that of Gordon Smith, is that such forces cannot be readily resisted by management and militate towards profit maximizing activities. Shareholder rights advocates accept implicitly (by failing to refute) that such forces are strong enough to counter pressure from labor to form a coalition with management, but argue that such forces are not strong enough to counter managerial slack and rent extraction itself. By removing obstacles to effective operation of the market for corporate control, Board veto and poison pills, market forces would inevitably compel greater profit seeking. The Varieties of Capitalism literature, earlier discussed, also predicts that managers and capital are more likely to coordinate on short-term strategies, as institutional complementarities like fluid labor markets, highly liquid capital markets, strong investor protection, and widely held ownership make these strategies more feasible in the LME. However, there is reason to question the extent to which capital market pressures can be resisted by directors and whether doing so could still result in productive and efficient firms.

A recent study from Australia, typically an LME, demonstrates that management of public and privately owned corporations, although strongly affected by product and capital market pressures, can for the most part, resist pressure from investors for immediate gains and still be successful over the long-run. The particularly intriguing aspect of this study is that firms with widely held ownership in the context of strong investor protection and fluid labor markets can develop partnership style relations with their employees defined as “situations in which business organizations are seen to work closely and cooperatively with their employees rather than contrary to their interests.”³⁴⁵ The authors focus their study on three principle factors dominant in the Varieties of Capitalism literature: corporate governance arrangements, the ownership structure of firms, and systems of employment and examine their intersection within the context of the legal-institutional environment to assess their impact on employee-management partnerships. Their findings challenge the dual model classification that underpins the comparative capitalism literature, demonstrating that significant variations of governance arrangements can exist within a particular LME due to other sets of factors that give rise to

³⁴⁵ Richard Mitchell, Anthony O'Donnell, Shelley Marshall, Ian Ramsay and Meredith Jones, *Law, Corporate Governance and Partnerships at Work: A Study of Australian Regulatory Style and Business Practice* (Ashgate Publishing 2011).

partnership type scenarios between workers and the corporation.

Several of the companies in the study, despite undergoing significant internal change as a result of their capital reorganization were able to exercise a fair degree of autonomy over corporate strategy. Using a company study and survey of corporate directors, the authors tested the presuppositions they made based on the VOC literature that the governance of a widely held company is more likely to correspond with prioritizing shareholder over stakeholder interests while a closely held company is less likely to be governed in the short-term interests of its shareholders.³⁴⁶ Some of the results of the survey were that 44% of directors ranked shareholders as their first priority while 40.4% ranked the company as their first priority.³⁴⁷ More notably, 55% percent of directors viewed acting in the best interests of the corporation as balancing stakeholder interests including employees despite the ownership structure of the company.³⁴⁸ Interestingly, the authors found that employees were highly ranked in other areas of the survey and where a shareholder-oriented governance outlook persisted it was not at the extreme end of the spectrum.³⁴⁹

³⁴⁶ *Ibid* 165.

³⁴⁷ *Ibid* 167.

³⁴⁸ *Ibid*.

³⁴⁹ *Ibid*.

PART IV-What is the Magnitude of the Current Shift in Governance Thinking? Is it Compatible with a Market-Based Approach?

CHAPTER EIGHT: Indicators of a Post Crisis Shift in Thinking

After analyzing how the current approach conflicts with corporate law's function in protecting the entity, we can examine post-crisis responses to compensation reform with a view to determining the extent to which the existing paradigm can accommodate the challenges identified. This is performed as a comparative exercise between two governance regimes, Germany's coordinated market economy and the liberal market economy of the United States.

The significance of comparing these jurisdictions is not only that their approaches to market regulation contrast but that they're equally subject to the Financial Stability Board's directive on executive pay reform. While several assessments of post-crisis responses to compensation reform, namely the implementation of the FSB Principles on Sound Remuneration Practices across the LME and CME spectrum, gravitate towards the conclusion that market-based norms of governance need to be improved through better contracting,³⁵⁰ a deeper assessment stands to reveal that such changes cannot be accommodated from this paradigm.

The overarching theme of controlling excessive risk-taking and advancing a longer term approach to running the firm, when implemented in either jurisdiction, calls forward an economic rationale on the part of directors that is inconsistent with efficiency and performance based norms of directorial conduct. Despite the attempt by mainstream scholarship to reconcile some of the differences that appear in regulatory responses between jurisdictions as fitting within the optimal contracting paradigm, these differences, it is argued, represent fundamentally divergent approaches to market governance.

While this has potentially significant implications for the convergence/divergence debate which underlies post-crisis assessments of compensation reform, from a methodological

³⁵⁰ For post-crisis assessments of regulatory responses to executive pay that gravitate towards this conclusion see Hausmann and Bechtold-Orth, *supra* note 18; Ferrarini and Ungureanu, *supra* note 23. See also Stephen Bainbridge, *supra* note 82 (arguing there is no real problem with executive pay in the post crisis context).

standpoint the issue is two-fold. First, it is important to assess whether differences in regulatory approach can be reconciled with shareholder primacy or whether they diverge. The result of this determines the position we can take on whether corporate governance is continuing to converge towards a more liberal market based model or whether the approaches of certain jurisdictions are diverging. While this in itself is instructive of shareholder primacy's efficacy in the post-crisis era, it does not show whether shareholder primacy in its own context reveals any internal consistencies with the need to constrain risk-taking and the pursuit of short-term profit. This gives rise to the second issue, whether post-crisis responses in the United States reveal at best a shift away from shareholder primacy and at least inconsistency with the need to run large public corporations sustainably and in the public interest. However, to determine whether such a shift is evident, we need a basis of comparison to determine where along a spectrum of governance approaches they might fit, hence again the need to rely on a comparative approach.

SECTION A: Framework of Analysis

The principal criterion of selection for these regulatory responses is that they have some type of impact on the Board of Directors' role moving forward from the crisis. These initiatives are not necessarily direct changes to directors' duties, although in the German context this seems to be the case. Many of these initiatives represent changes or refinements in the context that director's duties are understood. To examine these initiatives the following questions will be asked:

1. Does the provision represent a new behavioral norm for directors requiring additional due diligence, a consideration of new circumstances or the following of new procedures when setting or approving compensation?
2. Is it mandatory or enabling? Does it impose extra-economic or efficiency based norms of conduct? Does it require directors to account for how executive pay impacts the corporate entity or to engage predominantly in arm's length bargaining?
3. Is the effect of the provision such that it results in the interests of other stakeholders being taken into account by directors when setting executive pay and does it result in directors prioritizing the firm's well-being over immediate shareholder returns?
4. Is the effect of the provision such that directors utilize performance criteria other than share price to gauge whether executive compensation schemes are acceptable?

SECTION B: Norm Generation at the International Level: FSF Principles

As a response to the events that led to the crisis, the Financial Stability Forum (FSF) developed 9 principles for remuneration which pertain to senior employees in large firms.³⁵¹ At the time of their release and anticipated implementation by national banking and securities regulators in OECD nations, there was speculation that these principles would extend to large and systemically important firms outside the financial sector.³⁵² The 9 principles are as follows:

1. The firm's board of directors must actively oversee compensation system design and operation.
2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role.
4. Compensation must be adjusted for all types of risk.
5. Compensation outcomes must be symmetric with risk outcomes.
6. Compensation payout schedules must be sensitive to the time horizon of risks.
7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.
8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

In its final report which was a product of several consultations and reports engaged in by its Workstream Group, the FSF set-out its rationale behind such changes and particular issues that needed to be addressed.³⁵³ Of general importance was the shared belief by market

³⁵¹ Financial Stability Forum, "FSF Principles for Sound Compensation Practices" *FSF* (2009), Online: FSF, <http://www.financialstabilityboard.org/wp-content/uploads/r_0904b.pdf?page_moved=1>.

³⁵² Hill, *supra* note 14.

³⁵³ *Supra* note 352.

participants that executive remuneration practices were responsible for driving inappropriate risk-taking practices which culminated in the crisis.³⁵⁴ Of specific importance is the recognition that up until the crisis compensation systems for senior executives have been viewed predominantly as performance or risk-enhancing tools not related to risk management and governance. Risk management was handled outside the corporate governance realm and executive compensation was conceptualized as the principle governance tool, implemented to control managerial slack by spurring short-term profit creation.

This process of norm creation at the supra-national level, has identified the need to focus on how compensation systems can encourage managers to overwhelm existing risk management and control systems.³⁵⁵ In line with this rationale, is the need to recognize the risk implications of basing compensation systems strictly on the profit motive. The FSF makes it clear that the traditional risk management policies of financial institutions which focus on prudent credit granting and underwriting practices are not adequate to address the issue of risk-taking and the pursuit of aggressive short-term growth at the upper echelons of the organization.³⁵⁶ Thus, the norms developed by the FSF have broader implications for corporate governance practices outside the typical purview of banking regulation and financial sector governance.

The 9 principles can be divided across three areas.³⁵⁷ The FSF provides further rationale for why these are necessary:

1. Effective governance of compensation contained in principles 1 to 3.
2. Effective alignment of compensation with prudent risk-taking contained in principles 4 to 7.
3. Effective supervisory oversight and engagement by stakeholders contained in principles 8-9.

I. Effective Governance

According to the FSF, improving the effectiveness of how compensation is governed entails recognizing that directors must account for how compensation interacts with the institution's risk governance. Otherwise firms enacting enhanced risk governance measures risk

³⁵⁴ *Ibid.*

³⁵⁵ Hill, *supra* note 14.

³⁵⁶ FSB, *supra* note 354.

³⁵⁷ *Ibid.*

not complying with the substance of the required changes.³⁵⁸ A key development in this area is that Boards should be responsible for the compensation system's design and operation. The key thrust of this change is that delegation of compensation to independent experts or auditors is not a substitute for the Board's requirement to have their own expertise at understanding issues pertaining to risk in compensation. Boards can no longer rely on the self-regulating nature and design of executive pay incentives and must take actual charge in monitoring how compensation contributes to risk and to readily control and adjust compensation in relation to the firm.

The actual outcomes of compensation must be assessed against the compensation's intent with a view to ensuring these outcomes don't harm the firm. Of principal importance is to that current credit is not given for future revenue or growth within the compensation arrangement. Directors must actively monitor compensation systems to ensure they do not reward performance which hasn't yet materialized and concurrently to ensure that failed yet non-materialized risk is accounted for in the compensation structure.

II. Effective Alignment

According to the FSF, the second area focuses on the risk imposed by the senior employee on the firm which has not yet materialized.³⁵⁹ It highlights the need to make compensation sensitive to future risk outcomes, especially in the case of short-term profits generated by that employee. This is especially important where the executive's tenure is near its end and it pays for the executive to engage in short-term behavior and risk-taking, knowing that he will escape the consequences under current arrangements. Moreover, poor risk management results should in theory result in directors reducing payment to managers. With respect to ensuring that compensation is aligned with prudent risk-taking, FSF Principles 4-7 seek to ensure that directors assess outcomes of compensation against risk-management goals, ensuring compensation pay-out schedules reflect the potential for future risks.

These principles are a direct response to the problems in existing compensation schemes consisting largely of stock ownership. The FSF recognizes that such incentives expose managers to losses in stock value for poor performance, resulting in excessive risk-taking potentially to offset these losses, with little attention being paid to downside risk. Accordingly if weak relative

³⁵⁸ *Ibid.*

³⁵⁹ *Ibid.*

performance from managerial slack or exogenous forces punishes managers, then taking more risk is a way to offset this by boosting short-term performance. This is driven by the fact that many shareholders are focusing on short-term results, making equity prices sensitive to short-term performance criteria. The FSF concludes that traditionally structured options and bonus grants create incentives to take too much risk and that the goal should be to match executive incentives with the long-term stewardship of the firm. The FSF recognizes that the use of such tools would likely have to be curtailed and that this might have an impact on incentives for performance and talent retention.

III. Effective Supervisory Oversight

The FSF identifies the need for long-term supervisory oversight to offset countervailing pressures, presumably for short-term returns.³⁶⁰ It advocates for greater engagement by the firm's stakeholders in compensation related decisions which includes but is not limited to a greater role for shareholders. It can be reasonably inferred that this is not meant as a substitute for other measures proposed, but as a complementing measure. Principles 8-9 relate directly to the need for greater information disclosure, not only to shareholders but to regulators and governments where firms are systemically important, and for greater engagement with compensation decisions. Principles 8-9 in effect represent the FSF's endorsement of non-binding say on pay provisions. The FSF also identifies the need for supervisory authorities such as banking and securities regulators to actively monitor and identify and bring to the Board's attention, deficiencies in a firm's compensation arrangements. Direct intervention in compensation practices that are unsound from a risk standpoint is recommended for large systemically important financial institutions and possibly for other large non-financial institutions.

³⁶⁰

Ibid.

SECTION C: Norm Generation at the EU Level: CEBS Guidelines

The European Banking Authority “EBA” is an independent EU authority tasked with the prudential regulation and supervision of financial institutions in EU member states and for harmonizing prudential rules into a European Single Rulebook. The predecessor of the EBA was the Committee of European Banking Supervisors “CEBS” established in 2004 as an independent advisory group on banking supervision by the European Commission “EC”. Tasked with a directive of facilitating the convergence of financial supervisory practices in the EU, the committee played a key role on the European scene, developing standards for reforming executive compensation practices in response to the financial crisis. Mirroring to a large extent the principles disseminated by the FSF, the CEBS developed the 'High-level Principles for Remuneration Policies in response to the crisis.³⁶¹ The set of principles is as follows:

1. The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should be adequately rewarded to attract skilled individuals.
2. The remuneration policy should be transparent internally and adequately disclosed externally.
3. The management body, in its supervisory function, should determine the remuneration of the management body in its management function. In addition the management body, in its supervisory function, should approve the principles of the overall remuneration policy of the institution and maintain oversight of their application. The implementation of the remuneration policy should be subject to central and independent review.
4. Where the pay award is performance related, remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include adjustments for risks and the cost of capital.
5. There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure up-front cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.

³⁶¹ For an explanation of the principles see, CEBS, “High-level Principles for Remuneration Policies”, *CEBS* (20 April 2009), Online: <<https://www.eba.europa.eu/documents/10180/16094/High-level+principles+for+remuneration+policies.pdf>>.

Of key importance in these principles, is a focus on clearly separating supervisory and managerial roles at the upper echelons of the organization.³⁶² This distinction is characteristic of most corporate entities, but more pronounced in some EU members' corporate governance regimes such as Germany's co-determined board system. Following this distinction, the CEBS guidelines further emphasize the need to insulate performance-based aspects of an organization's internal governance from risk-management aspects.³⁶³ Thus, employees in risk-management and oversight positions are not to be rewarded based on the financial performance of the enterprise but on sound governance practices instead.

³⁶² *Ibid.*

³⁶³ *Ibid.*

CHAPTER NINE:

Conflicting Views on the Significance of Post-Crisis Responses to Compensation

Implementation of the FSF principles was intended to be executed by banking and securities regulators of OECD states and in the case of the CEBS Guidelines, by regulators in EU member states. Corporate law was to play a role, but its extent was unclear at the time. In the twelve month period after the crisis began to subside, legislators began to roll out various measures aimed at regulating executive compensation. This provided an opportunity for corporate scholarship to analyze these legal provisions and the approaches to governance they represent. The debates inherent in this analysis require further exploration to understand the conflict entrenched in narratives of compensation reform. Several differences and similarities exist with how nations choose to regulate compensation in response to the goals identified by the FSF and CEBS. These, for the most part, are accounted for as differences in the scope and intensity of the application of these principles and differing sets of compromises between rules versus principles based approaches.³⁶⁴ While comprehensive, such a legal analysis is limited for understanding the deeper issues at play. A legal analysis superficially reconciles differences in approach and takes for granted the underlying paradigm shift that might be occurring.³⁶⁵

In the post crisis analysis of compensation reform across several jurisdictions, two views to appear to exist. One is that current regulatory approaches are consistent with the shareholder primacy paradigm and represent improvements to how the optimal contracting model functions while the other is that post-crisis responses represent a paradigm shift away from optimal contracting. In the LME context each approach corresponds with either leaving directorial discretion intact or constraining business judgement with stakeholder based norms. In the case of

³⁶⁴ This is the mainstream view consistent with optimal contracting and a law and economics perspective more generally. See Hausmann and Bechtold-Orth, *supra* note 18; Ferrarini and Ungureanu, *supra* note 23; See Martin J. Conyon, Nuno Fernandes, Miguel A. Ferreira, Pedro Matos and Kevin Murphy, “The Executive Compensation Controversy: A Transatlantic Analysis”, paper presented at the Annual FRDB (Fondazione Rodolfo Benedetti) conference in Cagliari (29 May 2009), Online: FRDB, <<http://www.frdbrg.orgtupload/file/First.report.pdf>>.

³⁶⁵ At odds with this view is that differences in regulatory responses represent a shift away from optimal contracting. For a comprehensive analysis of regulatory responses which support this conclusion see Hill, *supra* note 14; see also Randall S. Thomas, “International Executive Pay: Current Practices and Future Trends” *Vanderbilt Law & Economics Research Paper No. 08-26* (2009), Online: SSRN, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1265122>; Jaap Winter, *supra* note 15.

corporate governance in the CME context, namely Germany, the debate manifests as either a continuation of convergence towards market based governance norms, with the consensus that the self-regulatory approach needs to be improved versus the view that coordinated market economies have renewed their path of divergence away from such norms.³⁶⁶

SECTION A: Compensation Reform as Market-Based Regulation

One branch of the literature can be viewed as fitting into a perspective on post-crisis regulation that accepts the optimal contracting model's efficacy as its core assumption. This view reconciles differences in approach using a legal perspective and by doing so is able to conclude that post-crisis responses are aimed at better aligning shareholder and manager interests to achieve better performance.

The fundamental objective of compensation reform identified is sustaining market confidence and promoting financial stability by removing incentives for inappropriate risk-taking by managers. Yet this analysis falls short of recognizing key differences between mandatory versus enabling rules.³⁶⁷ Without this distinction the law and economics approach's dominance can be taken for granted. A greater focus on whether enabling rules are being displaced by mandatory norms of conduct could lend itself to a more accurate analysis of whether a paradigm shift is occurring. While this approach clearly recognizes the need for firms to focus on long-term rather than short-term performance,³⁶⁸ it fails to assess how this is possible, what it actually takes and why it hasn't occurred up until now under current market-based arrangements.

The assumption seems to be that adjustments to compensation incentives can be made without considering the magnitude of such a shift or its structural significance. A primary means identified to long-term firm stewardship is the linking of total variable compensation to the overall condition of the firm.³⁶⁹ Yet, the extent to which a long-term governance orientation in

³⁶⁶ Mainstream scholarship views Germany's response as reinforcing markets and market mechanisms. See Ferrarini and Ungureanu, *supra* note 23. The other view is that German responses represent a shift away from relying on market forces towards increased reliance on mandatory norms of conduct defined by corporate law.

³⁶⁷ Hausmann and Bechtold-Orth for instance fail to make this distinction in explaining differences in post-crisis responses.

³⁶⁸ This is a consistent theme across most of the literature.

³⁶⁹ Sanjai Bhagat and Roberta Romano propose for instance propose that restricted stock options be used to align executive compensation with the firm's overall condition as opposed to short-term share price. This approach still relies exclusively on market-based criteria and does not consider how long-term stewardship can be achieved, See Bhagat and Romano, *supra* note 15.

the LME context is possible is not assessed let alone acknowledged, taking for granted what a long-term shift actually entails in the current legal institutional-framework. The question arising is whether such a proposal can be accommodated or whether it requires a different set of norms that insulate directorial decision-making from the economic dictates of the market.

SECTION B: Compensation Reform as Regulation of the Market

Another branch of the literature fits into the perspective that post-crisis regulation of executive pay represents a paradigm shift away from the non-interventionist approach.³⁷⁰ This approach recognizes the significance of executive pay being a corporate governance problem before the 1990s after which it was re-conceptualized as a corporate governance tool.³⁷¹ By recognizing the primary focus of this paradigm as the design of optimal contracts, this view is able to take account of any shift in approach that might be occurring.

The evidence to support the premise that such shift is occurring is multifaceted and can be found in a limited number of post crisis analyses of compensation reform. The first point observed from this viewpoint about the post-financial crisis landscape is that unlike Enron, executive pay is a major focal point of reform.³⁷² This is significant because under the previous post-Enron round of regulation, the focus was on the CEO's entitlement to their compensation and the misstating of earnings to appropriate more pay.³⁷³ This response tackled issues of fraud which to a large extent fell under the purview of fiduciary duties. The expanded focus on compensation incentives in the post-crisis round demonstrates a focus on how incentives work.

Given that short-termism and excessive risk are problematized as issues with wide ranging societal implications, this preoccupation extends well past the issue of performance and managerial slack. The framework used to analyze post-crisis regulatory responses by OECD nations is telling of a paradigm shift that might be occurring. However, the analysis is still limited by the legal lens employed. However, it is recognized that the choice between the arm's length bargaining or managerial power approaches presented in the previous version of this

³⁷⁰ Hill, *supra* note 14.

³⁷¹ *Ibid.*

³⁷² *Ibid.*

³⁷³ *Ibid.*

debate has shifted.³⁷⁴ Thus by appreciating the evolution of the pay debate and its transition into the law and economics paradigm, this approach is equipped to recognize developments outside of its confines, making it possible to identify several regulatory themes which serve as evidence that compensation reform currently focuses on a wider set of actors.

SECTION C: Regulatory Themes Identified

This viewpoint identifies incentive compensation and the performance-based approach as giving rise to previously un contemplated governance problems. Professor Hill identifies five key regulatory themes aimed at tackling these issues.³⁷⁵ They are as follows:

1. A risk-based approach to setting executive pay.
2. A focus on long-term sustainability of the corporation when setting pay.
3. A re-evaluation of the previous concept of interest alignment.
4. A re-evaluation of previous short-term market-based performance measures.
5. A focus on income inequality when setting pay.

I. Risk and Executive Pay

Further evidence of an emerging risk-based approach includes a focus on the outwards effects of risk, namely the public's exposure to financial market risk. This includes recognition by mainstream law and economics academia that compensation incentives create a moral hazard situation for risk-taking by top executives³⁷⁶ accompanied by the now prevalent view that compensation incentives have themselves become a risk management problem. The Federal Reserve for instance emphasizes the importance of incentive compensation not jeopardizing the soundness of an institution.³⁷⁷

³⁷⁴ *Ibid.*

³⁷⁵ *Ibid.*

³⁷⁶ Bebchuk and Spamann, *supra* note 19.

³⁷⁷ Federal Deposit Insurance Corporation, "Guidance on Sound Incentive Compensation Policies" *Statements of Policy* (2010), Online: FDIC, <<https://www.fdic.gov/regulations/laws/rules/5000-5350.html>>.

II. Short-termism versus Long-termism

Evidence of a shifting focus from short-termism to long-termism that supports this perspective can be found in the scholarship.³⁷⁸ The concern amongst regulators is that incentive compensation currently drives executives to focus on short-term profits while creating long-term organizational risk.³⁷⁹ A consensus seems to be emerging that the new goal of executive remuneration is to promote sustainable corporate performance.³⁸⁰ This is consistent with the FSB's principles and is also acknowledged by the self-regulatory approach as a key goal of compensation reform. It is not, on its face, evidence of a paradigm shift. Contractarians argue that a longer term focus is possible with the market-based approach.³⁸¹ However, the broader approach to reform taken by contractarians, gives rise to questions over what a long-term sustainable approach entails. Yet these questions fade into the background when the broader scope of executive pay's conceptual evolution in the LME context is not taken into account.

The consensus on how to achieve a longer-term approach is two-fold: modifying compensation design and claw-back provisions.³⁸² A solution in the former area is for Boards to re-design pay by tying total remuneration to long-term outcomes. This includes using mandatory holding periods for equity pay and deferred vesting of options built into contracts.³⁸³ Claw-back provisions while implemented in the wake of the Enron scandal in the U.S. have been proposed as a regulatory constraint on short-termism in several jurisdictions.³⁸⁴ This includes the requirement for all public firms to have a claw-back policy regardless of misconduct.³⁸⁵ This is an extension of the previous measure permitting the Board to recover compensation awarded as a

³⁷⁸ See Hill, *supra* note 14; Lucian Ayre Bebchuk and Jesse M. Fried, "Paying for Long-Term Performance" (2009) 158 *U of Penn L R* 1915; Bhagat and Romano, *supra* note 15.

³⁷⁹ FSF, *supra* note 354; US Department of the Treasury, "Treasury Announces New Restrictions on Executive Compensation" *US Government Press Release* (4 February 2009), Online: US Treasury, <http://www.treasury.gov/press/releases/tg15.htm>.

³⁸⁰ *Ibid.*

³⁸¹ This, for instance, is a claim made by Hansmann and Kraakman in the 'End of History', *supra* note 146; see also Lucian Bebchuk and Jesse Fried, *supra* note 90.

³⁸² The consensus against scholars and financial industry regulators is that compensation design needs to be modified while the SEC is taking the approach of expanding directors' power to reel in excessive pay packages obtained by misrepresentation. Both are aimed at curbing short-term behavior and promoting greater sustainability.

³⁸³ See Bhagat and Romano, *supra* note 15.

³⁸⁴ This works by allowing Boards to re-coup executive pay earned by manipulating short-term earnings. Since the Board is able to act retro-actively when the long-term effects of this manipulation materialize, managers in theory should be less inclined to act dishonestly for the sake of short-term gains.

³⁸⁵ Jesse M. Fried and Nitzan Shilon, "The Dodd-Frank Claw-Back and the Problem of Excess Pay" *The Corporate Board* (Jan-Feb 2012), Online: Harvard Law, <<http://www.law.harvard.edu/faculty/jfried/1201FriedShilon.pdf>>.

result of misstatement or fraud.³⁸⁶ In sum, several jurisdictions have adopted the claw-back measure to address negative long-term developments which crystallize as a result of short-term strategies aimed at bolstering the executive's compensation in the current period.³⁸⁷

III. Re-evaluation of Interest Alignment

This compelling observation demonstrates a possible paradigm shift away from optimal contracting towards a regulatory-oriented model implicating mandatory norms as opposed to a 'governance by self-interest' approach. Hill cites that aligning shareholder and executive interests through compensation is no longer the principal rhetoric of governance reform.³⁸⁸ The evidence includes statements by the U.S. Treasury that pay should be aligned with the interests of taxpayers who provided financial assistance to bail-out the largest firms.³⁸⁹ Again, the justification cited was that the shareholder-centred approach to governance, in the case of banks, allows shareholders to benefit from and exploit a greater level of risk than what is appropriate for the corporation's stability.³⁹⁰ Accordingly, part of this re-assessment includes determining whether the size of pay is publicly defensible.³⁹¹

IV. Re-evaluation of Performance Measures

The observations supporting the view that a shift is occurring away from optimal contracting include the adoption of non-financial performance criteria in several jurisdictions which represent goals tied to sustainable performance.³⁹² Accordingly, the CEBS guidelines hold that unethical behavior should trump positive financial performance³⁹³ and the AICD guidelines in Australia state that improved workplace safety should be a criterion for evaluating the CEO's

³⁸⁶ Claw-back provision were initially brought in under Sarbanes-Oxley. See Gibson Dunn, "Claw-backs" of Executive Compensation" *Gibson Dunn* (9 July 2008), Online:

<<http://www.gibsondunn.com/publications/Pages/ClawbacksOfExecutiveCompensation.aspx>.

³⁸⁷ Amongst these are Australia. See Australian Treasury Department, "The Claw-back of Executive Remuneration Where Financial Statements are Materially Misstated" *Government of Australia Discussion Paper* (December 2010), Online: Australian Treasury, <<http://archive.treasury.gov.au/documents/1926/PDF/101220%20Clawback%20of%20executive%20remuneration%20-%20Final%20-%20Approved.pdf>>.

³⁸⁸ Hill, *supra* note 14.

³⁸⁹ US Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" *US Government* (2009), Online: US Treasury, <<http://www.treasury.gov/press-center/press-releases/Pages/20096171052487309.aspx>>; Timothy Geithner and Lawrence Summers, "The Case for Financial Regulatory Reform" *Washington Post* (June 15 2009), Online: WP, <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443.html>.

³⁹⁰ US Treasury, *Ibid*.

³⁹¹ Hill, *Ibid*.

³⁹² Hill, *Ibid*.

³⁹³ Committee of European Banking Supervisors, "Guidelines on Remuneration Policies and Practices" *CEBS* (10 December 2010), Online: <https://www.eba.europa.eu/documents/10180/106961/Guidelines.pdf>.

performance.³⁹⁴ While these examples are not mandatory in LME jurisdictions, they depart from the optimal contracting model's focus on shareholder returns as the principal measure of good governance. The issue is whether Boards will adopt such measures and whether shareholders have an incentive to do the same.

V. Income Inequality

The final regulatory theme evident in the literature is an increased focus on the link between income inequality and the CEO's pay.³⁹⁵ The crux of this concern is that a high level of income disparity between the work force and top management of the firm demotivates front-line workers and contributes to poor long-term sustainability.³⁹⁶ This observation is congruent with the stakeholder perspective on executive pay discussed earlier in this paper. Part of this focus has been on the actual fairness of compensation and not just on how production is affected.

³⁹⁴ Australian Institute of Company Directors, "Executive Remuneration: Guidelines for Listed Company Boards" *AICD* (29 May 2009), Online: AICD, <http://archive.treasury.gov.au/documents/1584/PDF/Australian_Institute_of_Company_Directors.pdf>.

³⁹⁵ Hill, *supra* note 14.

³⁹⁶ See ALF-CIO, *supra* note 132; Randall Thomas, *supra* note 122.

CHAPTER TEN:

Executive Pay in the United States

SECTION A: Background and Context

The context of US pay reform involved addressing particular practices that led to the US financial collapse. In 2007 the prevalence of excessive risk-taking practices in major US banks came to light when the market for mortgage securities, including Collateralized Debt obligations (“CDOs”) experienced major downgrades.³⁹⁷ Similar failed debt securities prompted major bank-write downs, causing even triple “A” rated debt to lose its value. In January of 2008, the market for CDOs collapsed throughout the world causing more than \$2 trillion of wealth to evaporate overnight. The social effects of this market instability were far reaching.

From the outset, perverse executive compensation incentives were purported to have caused managers to engage in extreme profit-seeking which overwhelmed the checks and balances of existing governance systems in banks.³⁹⁸ Unlike the Enron debacle which reflected a concern over inadequate checks and balances in the accounting and disclosure realms and with the ability of managers to extract rents from the firm by misstating earnings, this time around the focus was on the drivers of such behaviours.³⁹⁹

Another back-drop against which specific and general measures to compensation reform were engaged with, was the recognition of the widespread systemic effects of such events and the significance they have for how capitalism in the US is organized.⁴⁰⁰ Legislators were concerned quite intensely with the prospect that taxpayer money was used to bail-out the biggest banks in the US who arrived at this position by their preoccupation with short-term earnings fuelled essentially by investor and managerial greed.⁴⁰¹ Initial responses demonstrated an effort

³⁹⁷ Wulf A Kaal and Richard W Painter, Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States (2010) 40(4) *Seton Hall L R* 1433; See also Michael Lewis, *The Big Short: Inside the Doomsday Machine* (London: Allen Lane, 2010) at 201-252 (explaining the steps which led to the crisis).

³⁹⁸ See Tom Braithwaite, “US will Appoint ‘Pay Tsar’ to Vet Executive Packages” *Financial Times US* (11 June 2009), Online: FT, <<http://www.ft.com/cms/s/0/28094a32-5621-11de-ab7e-00144feabdc0.html#axzz3SAAs1dt2>>.

³⁹⁹ John C. Coffee, “What Caused Enron? A Capsule Social and Economic History of the 1990s” (2004) 89 *Cornell Law Review* 269.

⁴⁰⁰ See for instance International Monetary Fund, “Global Financial Stability Report, Containing Systemic Risks and Restoring Financial Soundness” *IMF* (2008), Online, IMF, <<http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf>>.

⁴⁰¹ *Ibid.*

to protect future taxpayers from such an event reoccurring, evident in the acute response by the US Department of Treasury to controlling the size and structure of executive compensation in firms requiring government bail-out assistance.⁴⁰² Managers' of such firms could not avoid such harsh regulatory measures without first paying back the government and exiting the program.

SECTION B: The U.S. Response to Compensation Reform

The response in the U.S. consists of an initial response to the specific issues surrounding executive pay in distressed firms falling under the Troubled Assets Relief Program (“TARP”)⁴⁰³ followed by general reforms to corporate governance through the “*Dodd-Frank*” *Wall Street Reform and Consumer Protection Act* (“*Dodd-Frank Act*”).⁴⁰⁴ Other responses include the *Compensation Fairness Act* and the *Corporate Governance Reform Act*⁴⁰⁵ which was passed by Congress only to be defeated by the Senate. The provisions of the *Dodd-Frank Act* to a certain extent mirror the goals and provisions of these acts notwithstanding the changes made.

SECTION C: Specific Measures (Overview)

Being a temporary and drastic measure, the TARP program and specific measures taken to stabilise the economy are outside the scope of this analysis. Instead, general measures will be analysed in detail as they relate to executive compensation because they represent purported long-term changes to corporate governance geared towards preventing another crisis. Briefly the specific measures can be categorised as followed:

⁴⁰² The Treasury sought early-on to limit the size of the compensation received by executives of firms receiving bail-out assistance. See US Treasury, *supra* note 390; See also Braithwaite, *supra* note 455.

⁴⁰³ US Treasury, *supra* note 390.

⁴⁰⁴ Baird Webel, “The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary” *Congressional Research Service-CRS Report for Congress* (29 July 2010), Online: Legis Storm, <http://www.legistorm.com/reports/view/crs/61852/The_Dodd_Frank_Wall_Street_Reform_and_Consumer_Protection_Act_Issues_and_Summary.html>.; See also Securities Exchange Commission, “Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules” *SEC* (28 October 2013), Online: <http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml>.

⁴⁰⁵ Michael V. Seitzinger, “Executive Compensation: SEC Regulations and Congressional Proposals” *Congressional Research Service-CRS Report for Congress* (14 August 2009), Online: Waxman House, <http://waxman.house.gov/sites/waxman.house.gov/files/documents/UploadedFiles/Exec_Compensation.pdf>.

A. TARP Program

- i. Office of the Special Pay Master
- ii. Claw-back Requirements
- iii. Limitations on Bonuses
- iv. Limitations on Severance Pay
- v. Say on Pay

B. Guidance on Sound Incentive Compensation Policies

- i. Balanced risk taking incentives
- ii. Compatibility with effective controls and risk-management
- iii. Strong corporate governance
- iv. Proposed supervisory initiatives

SECTION D: General Measures (Overview)

The *Dodd-Frank Act* as it relates to the reform of executive compensation in the U.S. can be assessed across 5 key areas. These areas act as general measures to reform how executive compensation is set in public companies regulated by the SEC. The key provisions in the area of executive pay are as follows:

- Say on pay
- Publication of worker to CEO wage ratio
- Enhanced disclosure obligations
- Mandatory claw-back policy for public companies
- Independent compensation committees

SECTION E: Say on Pay

Section 951 of the *Dodd-Frank Act* provides shareholders with an advisory vote on disclosed executive compensation plans.⁴⁰⁶ The provisions amend the *Securities Exchange Act of 1934*,⁴⁰⁷ by inserting section 14A. It provides shareholders with a right to approve executive compensation not less frequently than once every 3 years at the annual general meeting or other

⁴⁰⁶ *Dodd-Frank Wall Reform and Consumer Protection Act*, s 951.

⁴⁰⁷ 15 U.S.C. 78a et seq.

meeting where SEC rules require compensation disclosure.⁴⁰⁸ The vote must be exercised through a separate resolution included in proxy, consent or authorization materials.⁴⁰⁹ The provision also requires shareholder approval of golden parachute compensation in a separate resolution and disclosure of any such arrangements or understandings between an executive officer and an acquiring firm. The rules of construction under this provision prevent the shareholder vote from being binding on the Board or the corporation. Having final say, the Board cannot be overruled on matters relating to executive pay and directors' fiduciary duties are not extended or changed in any way either explicitly or by implication.

SECTION F: Enhanced Disclosure Obligations

Section 953 (a) of the Dodd-Frank Act creates enhanced general disclosure requirements for executive compensation in publicly listed corporations.⁴¹⁰ The final rules require corporations to disclose how they handle and reward safe and excessive risk-taking. The aim of this amendment is to curtail undue risk-taking by providing greater information to shareholders who can exercise their right to sell or not to buy.⁴¹¹ With enhanced disclosure of such risk, the capital market in theory can discount a corporation's share price where excessive levels of risk are rewarded by the compensations structure. The disclosure threshold is whether the compensation for any employee in the firm is reasonably likely to create a materially adverse effect on the company. Another key feature is the requirement to provide "a non-exclusive situational list of when a compensation practice is reasonably likely to create materially adverse risk to the company."⁴¹²

SECTION G: Publication of Worker to CEO Wage Ratio

⁴⁰⁸ For a summary of this provision's proposed content, scope and application see Gary Shorter, "Say on Pay and Other Corporate Governance Reform Initiatives" *Congressional Research Service, CRS Report to Congress* (13 August 2009), Online: https://waxman.house.gov/sites/waxman.house.gov/files/documents/UploadedFiles/Say_on_Pay_and_Other_Initiatives.pdf

⁴⁰⁹ Securities Exchange Commission, "Shareholder Approval of Executive Compensation and Golden Parachute: Final Rule" *SEC* (4 April 2011), Online: <<https://www.sec.gov/rules/final/2011/33-9178.pdf>>; See also Securities Exchange Commission, "Office of Investor Education and Advocacy, "Investor Bulletin: Say on Pay and Golden Parachute Votes" *SEC* (11 March 2011), Online: <<http://www.sec.gov/investor/alerts/sayonpay.pdf>>.

⁴¹⁰ *Dodd-Frank Wall Reform and Consumer Protection Act*, s 953.

⁴¹¹ For a summary of this provision's content, scope and application see Securities Exchange Commission, "Proxy Disclosure Enhancements: Final Rule" *SEC* (28 February 2010), Online: <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

⁴¹² *Ibid.*

Section 953(b) of the *Dodd-Frank Act* creates additional disclosure requirements, requiring publicly listed firms to disclose a) the median annual compensation of all employees, b) the annual total compensation of the CEO and c) the ratio between these two figures.⁴¹³ The provision requires the SEC to create rules implementing a requirement for firms to disclose these figures.⁴¹⁴ On Sept 18, 2013 the SEC released proposals to implement such requirements.⁴¹⁵ The disclosure is mandatory on a quarterly basis. The aim of this amendment is to provide public data that is more comprehensive with regard to the effects of wage disparity on corporate performance, with the expectation that shareholders and the public will pressure corporate Boards to be more restrained.⁴¹⁶ The provision addresses a Board-CEO dynamic where directors feel beholden to the CEO. The managerial power approach provides theoretical support for the problem this provision seeks to address. However, this solution is at odds with the optimal contracting approach which posits that CEOs operate in a competitive marketplace in which the value that they give to shareholders is fairly compensated. Also consistent with managerial power theory, the provision enables public outrage constraints to operate by enhancing the ability of consumers, labor groups, and pension funds to assess whether compensation is appropriate in relation to workers' compensation.⁴¹⁷

SECTION H: Mandatory Claw-back Policy for Public Companies

Section 954 of the *Dodd-Frank Act* dealing with “recovery of erroneously awarded compensation” establishes a requirement for publicly listed companies to develop and implement claw back policies which obligate the Board to recover excessive pay obtained through the misrepresentation of earnings or the inaccuracy of assessment criteria.⁴¹⁸ By imposing a

⁴¹³ *Dodd-Frank Wall Reform and Consumer Protection Act*, s 953 b.

⁴¹⁴ See Gary Shorter, “The “Pay-Ratio Provision” in the Dodd-Frank Act: Legislation to Repeal It in the 113th Congress” *Congressional Research Service, CRS Report to Congress* (28 October 2013), Online: <<https://www.fas.org/sgp/crs/misc/R43262.pdf>>.

⁴¹⁵ Securities Exchange Commission, Pay Ratio Disclosure: Proposed Rule” *SEC* (18 Sept 2013), Online: <<http://www.sec.gov/rules/proposed/2013/33-9452.pdf>>.

⁴¹⁶ AFL-CIO, *supra* note 124.

⁴¹⁷ See Bebchuk and Fried, *supra* note 94.

⁴¹⁸ Section 954 of Dodd-Frank adds a new section 10D to the *Securities Exchange Act 1934*. The new provision instructs the SEC to issue rules directing each national securities exchange to require every listed company to put in place a claw-back policy to recover certain incentive compensation paid to executives when the firm is required to prepare an accounting restatement. See Davis Polk & Wardell, “Compensation Claw-back Under Dodd-Frank: Impact on Foreign Issuers” *Davis Polk Memorandum* (7 September 2011), Online: Davis Polk, <www.davispolk.com/.../2011.09.Dodd.Frank.Compensation.Clawback.v3_sep11.pdf>.

requirement for directors to directly confront the problem of managerial rent extraction, this provision deals with the excessiveness problem and is consistent with protecting the corporate entity. The claw-back provision is not intended to address factors which purportedly exacerbate the propensity of managers to commit fraud, such as perverse incentives, but instead seeks to raise a greater barrier to such conduct.⁴¹⁹ The approach is also consistent with the understanding that this particular manifestation of managerial power cannot be fully restrained through an improved version of performance based incentive compensation.

In contrast to the claw-back provisions under section 304 of the *Sarbanes-Oxley Act* (“*SOX*”), the *Dodd-Frank Act* provisions do not enhance the SEC's authority to prosecute for excessive compensation obtained through misconduct.⁴²⁰ This existing *SOX* provision remains intact. Cited as the most significant federal intervention into corporate governance since the 1930's, section 304 of *SOX* gives the SEC the power to require a CEO or CFO to return any bonuses or incentive compensation, including profits from the sale of stock, if the firm is required to prepare an accounting re-statement due to material non-compliance.⁴²¹ There however, must be an accounting re-statement and a finding of misconduct otherwise the SEC cannot act if the compensation awarded is simply excessive.⁴²² The *SOX* provision also provides the Board of Directors with the right to recover excess pay stemming from the use of improper assessment criteria or errors in calculation.⁴²³ This legal tool benefits shareholders by helping to recover funds that would otherwise constitute earnings, improving pay-to-performance sensitivity by making rent extraction less feasible and counterbalancing incentives to engage in fraudulent conduct which can weaken or destroy a firm.⁴²⁴

The *SOX* claw-back provision is purported to have several weaknesses some of which the *Dodd-Frank Act* seeks to improve upon. Despite, the SEC's ability to require a firm's CEO or CFO to disgorge the benefits obtained from misstated earnings, the *SOX* provision can only be deployed in cases where the SEC can demonstrate misconduct which is often difficult to

⁴¹⁹ *Ibid.*

⁴²⁰ Hill, *supra* note 14.

⁴²¹ See Jill Radloff, “Dodd-Frank, Sarbanes-Oxley and Claw-backs” *Stinson Leonard Street* (6 August 2010), Online: Dodd-Frank.Com, <<http://dodd-frank.com/dodd-frank-sarbanes-oxley-and-clawbacks/>>.

⁴²² *Ibid.*

⁴²³ *Ibid.*

⁴²⁴ See Fried and Shilon, *supra* note 80.

establish. ⁴²⁵ Neither directors nor shareholders have a right to sue on behalf of the corporation to enforce this provision. ⁴²⁶ Even without the SEC's involvement, directors are highly reluctant to implement claw back policies let alone enforce their provisions. ⁴²⁷ A majority of excess claw-back policies before *Dodd-Frank Act* came into force gave discretion to directors not to re-coup excess pay even if the executive had engaged in misconduct. ⁴²⁸

SECTION I: Analysis

1. Does the provision represent a new behavioral norm for directors requiring additional due diligence, a consideration of new circumstances or the following of new procedures when setting or approving compensation?

I. Say-on-pay

While say-on-pay requires taking additional procedural steps when setting executive pay there is no direct impact on directors' duties. In fact, the rules of construction prohibit fiduciary duties from being construed as altered or enhanced. ⁴²⁹ However, the precatory vote does exert some degree of pressure onto directors, by expressing at the very least that shareholders disagree with the size of the executive's compensation or whether it rewards risk. As many critiques have suggested, the effectiveness of this pressure remains to be seen. ⁴³⁰

Accepting that a potential exists for the precatory vote to influence directors' discretion, the amendment can be viewed as either enhancing shareholders' ability to discipline managers on behalf of the entity or as increasing their ability to endorse higher levels of pay and risk-taking for the chance to make short-term profits. This is dependent on shareholders' willingness to disapprove of high levels of pay and risk-taking, which will likely be influenced by current share price and individual investment horizons.

⁴²⁵ *Ibid.*

⁴²⁶ *Ibid.*

⁴²⁷ *Ibid.*

⁴²⁸ *Ibid.*

⁴²⁹ SEC, *supra* note 545.

⁴³⁰ See Shorter, *supra* note 465. For a critique see Bainbridge, *supra* note 80.

II. Enhanced disclosure obligations

By creating additional requirements to disclose risks that are materially adverse to the firm and how they are rewarded, this provision introduces a new behavioral norm from a procedural standpoint only. Otherwise, it merely provides shareholders with greater information on which they can assess risk. While this information includes specifically how executive pay impacts risk-taking by executives, directors are not faced with following a new behavioral norm, however are forced to think about how executive pay corresponds to risk, which might have an indirect effect on their decisions. This has not been studied let alone proven.

III. Publication of Worker to CEO Wage Ratio

The publication of the CEO-to-worker pay ratio does require directors to consider new circumstances, namely the relationship between front line worker and CEO pay and how this might affect long-term firm performance. The potential exists for directors to act according to a new set of stakeholders-based norms. This entails considering how worker morale might be affected by high levels of internal wage disparity, how poor worker morale might impact workers' productivity and commitment to the firm and how this impacts sustainability and overall firm performance in the long-run.⁴³¹

IV. Mandatory Claw-back Policy for Public Companies

This provision represents a strengthening of existing norms centred on protecting the corporate entity. This serves as an extension of the post-Enron response to fraudulent conduct by managers. The response itself focuses on raising a stronger barrier to fraudulent conduct and not on curbing pay incentives which create a stronger incentive to misrepresent earnings.

2. Is it mandatory or enabling? Does it impose extra-economic or efficiency based norms of conduct? Does it require directors to account for how executive pay impacts the corporate entity or to engage predominantly in arm's length bargaining?

⁴³¹ This is consistent with a stakeholder perspective on executive compensation. See Thomas, *supra* note 122.

I. Say-on-pay

From a procedural standpoint, the provision is mandatory in that Boards must provide for and allow the shareholder vote. However, there is no substantive right for shareholders to enforce their preferences and no mandatory norms of conduct are imposed.⁴³² Given that pressure arising from a majority vote against compensation could influence directors' discretion, shareholders could exhibit pressures to favor efficiency based governance norms, approving only compensation that is structured to reward high levels of profit and risk-taking and not necessary sound risk management practices. However, the possibility exists for shareholders, as a majority, to approve only those compensation arrangements that include stakeholder-friendly norms such as non-financial performance criteria and lower levels of pay more generally.

II. Enhanced disclosure obligations

Again, from a procedural standpoint, the provision is mandatory, however no additional extra-economic norms based on trust, loyalty, stewardship of the entity, or stakeholder well-being are imposed by this requirement.

III. Publication of Worker to CEO Wage Ratio

In short, disclosure of the CEO-to-worker pay ratio imposes mandatory norms of conduct but in a procedural sense. Aside from prompting directors to consider how executive pay impacts stakeholders and how this in turn impacts long-term performance, the enforcement of these norms rests in the hands of shareholders who may see a benefit in reducing the corporation's internal pay gap.⁴³³ Extra-economic norms of conduct are not imposed and neither are directors required to consider how executive pay impacts the entity. In fact, shareholders would likely implement these norms only if it translates into greater efficiency and profit.

IV. Mandatory Claw-back Policy for Public Companies

The norms underlying this provision are consistent with an extra-economic understanding of directors' duties. The provision requires directors to assess how fraudulent behavior by

⁴³² Shorter, *supra* note 471.

⁴³³ AFL-CIO, *supra* note 124.

management amounts to appropriation of the firm's assets. This is consistent with corporate law's traditional role in controlling self-interested behavior. In fact, the enforcement mechanism behind this provision, the threat of de-listing for non-complying issuers is arguably an effective and less onerous process than the derivative action available to shareholders. However, directors are not required to actually reduce pay under this provision, only to implement a policy for how such pay should be reduced. The enforcement mechanism for achieving a substantive result is still within the discretion of directors, subject to pressure from shareholders.

3. Is the effect of the provision such that it results in the interests of other stakeholders being taken into account by directors when setting executive pay and does it result in directors prioritizing the firm's well-being over immediate shareholder returns?

I. Say-on-pay

Again, the provision creates no substantive rights for shareholders nor does it instruct directors to follow a particular set of norms. Shareholders might indirectly influence directors, however there is no certainty that shareholders will advocate for stakeholder interests being taken into consideration or that executive pay incentives are aligned with long-term sustainable management of the firm.

II. Enhanced disclosure obligations

In assessing the relationship between the executive's pay and different levels of risk taking for the purposes of disclosure, directors might be required to assess the risk on different stakeholders, including taxpayers, workers, shareholders and the corporation. Thus, for the purposes of disclosure they might contemplate the entity's well-being over those of shareholders. However, assuming that shareholder pressure through the precatory vote exists, directors might prioritize short-term profit ahead of the corporation's well-being to gain the support of shareholders in the vote.

III. Publication of Worker to CEO Wage Ratio

As mentioned the provision does require directors to consider how CEO pay might impact workers, but only for the purpose of satisfying a procedural requirement. There is no certainty that disclosing this stakeholder-based measurement criteria will result in directors

prioritizing the firm's well-being over immediate returns. The potential for such a management orientation arises from two sources. One is the propensity of directors to act on stakeholder-based norms of conduct if they fall in line with the corporation's best interests. The consideration of this new relationship between stakeholders and long-term firm performance might prompt such an orientation. Two is pressure from shareholders to lower CEO pay to reduce internal wage disparity. This depends on shareholders recognizing the possible detriments of not lowering pay.

IV. Mandatory Claw-back Policy for Public Companies

In short, this provision does not result in the interests of stakeholders being taken into account. It is a straightforward application of fiduciary duties towards the entity. Because it focuses on a narrow aspect of managerial power, fraud, the provision is limited in scope to addressing the symptoms of managerial power and not the causes. This fails to recognize that other governance measures, namely the high-powered pay incentive, can exacerbate managerial power and conflict with the goal of this provision.

4. Is the effect of the provision such that directors utilize performance criteria other than share price to gauge whether executive compensation schemes are acceptable?

I. Say-on-pay

Directors have the same discretion as before to establish and reward a wide range of corporate purposes. There is no guidance provided to shareholders or standards articulated to utilize non-market based performance criteria. This is strictly optional. Although the disclosure of the CEO-to-worker pay ratio and materially adverse risks discussed above, might inform how shareholders assess the appropriateness of the pay they are voting on.

II. Enhanced disclosure obligations

While, disclosing the relationship between executive pay and adverse risks to the firm introduces new and potentially long-term criteria for assessing performance, directors are not required to act on this criteria. Provided that directors take cues from shareholder voting when setting executive pay, they might not consider these criteria if shareholders opt for more risk-taking and larger executive pay for the promise of aggressive growth.

III. Publication of Worker to CEO Wage Ratio

Again, by requiring directors to calculate and disclose this ratio, they are prompted to contemplate non-financial criteria as a basis for assessing the corporation's best interests. If a positive correlation is contemplated between high CEO pay and unsustainable long-term performance then directors might assess such compensation negatively and reduce it. Another factor not previously discussed, is the effect of managerial power on directors and how strong managerial influence might prevent directors from acting on this alternative criteria.

IV. Mandatory Claw-back Policy for Public Companies

In short, this provision is not geared towards assessing the appropriateness of pay, nor does it address its substantive effects. It deals instead with mitigating the effects of inappropriate incentives by strengthening directors' role to discipline rent-seeking.

CHAPTER ELEVEN: Executive Pay in Germany

SECTION A: Background and Context

Recent developments in Germany around executive pay follow a period of relative controversy surrounding both its size and structure.⁴³⁴ Amidst uncertainty and intense debate over the path of corporate governance in Germany, executive compensation has emerged as a regulatory contest between the influence of Anglo-American liberal market pay practices and the stakeholder-oriented goals which underlie how German executives are paid. German corporate governance in the years before the Financial Crisis was marked by a heated debate over the appropriateness and legality of paying large, American-style bonuses to German executives on the Management Boards of public corporations, for orchestrating stupendous short-term gains for

⁴³⁴ The late 1990's in Germany marked a controversial period of reform for German company law characterized by the liberalization of finance while at the same time, the persistence of Co-determination. See Cioffi, *infra* note 454.

shareholders. At the heart of this debate was the Mannesmann ordeal which several commentators referred to as placing Germany's entire system of embedded capitalism on trial.⁴³⁵

I. The Broader Context of EU Market Integration and Reform

The broader context in which to assess the drivers of executive pay reform in Germany is the European Commission's market building initiative. Ongoing since 1986, the Single Market project has increasingly integrated European product, financial and labour markets, giving rise to various rounds of harmonization of regulatory norms and practices.⁴³⁶ Beginning with the First Council Directive in 1968, European company law regulation and its push to provide an equivalent level of investor protection across member states has played a crucial role in this process of harmonization and integration.⁴³⁷

The Commission's Modernization of Company Law and the Enhancement of Corporate Governance body has been an active site for the generation and dissemination of corporate governance norms and practices.⁴³⁸ The source of several proposals, recommendations, high-level reports, and action plans, this diverse and amorphous collective of state and non-state experts have driven the process of European Corporate Governance Regulation (ECGR) along its current trajectory.⁴³⁹ Having entered the scene in 2001 with the Commission's White Paper, the concept of EU governance is now entrenched in the semi-autonomous field of ECGR.⁴⁴⁰

The European Corporate Governance Forum (ECGF), established in 2004 by the European Commission, consists of member state representatives, issuers of securities, investors and academics that meet regularly to advise the Commission on the effectiveness of members'

⁴³⁵ Peter Kolla, "The Mannesmann Trial and the Role of the Courts" (2004) 5 *German Law Journal* 829; Stefan Maier, "A Close Look at the Mannesmann Trial" (2006) 7 *German Law Journal* 603; See also Jobst-Hubertus Bauer, "Boards Beware" (2006) 25(12) *International Financial Law Review* 52.

⁴³⁶ European Commission, "Company Law and Corporate Governance" EC (22 April 2014), Online: EC, <http://ec.europa.eu/internal_market/company/index_en.htm>.

⁴³⁷ *Ibid.*

⁴³⁸ See Peer Zumbansen, "New Governance' in European Corporate Law Regulation as Transnational Legal Pluralism" (2009) 15(2) *European Law Journal* 246.

⁴³⁹ *Ibid.*

⁴⁴⁰ Zumbansen, *ibid*; see also European Commission, "European Governance, A White Paper" EC (25 July 2001), Online: EC, <http://eur-lex.europa.eu/LexUriServ/site/en/com/2001/com2001_0428en01.pdf>.

monitoring systems and to assist in developing corporate governance codes.⁴⁴¹ Of notable importance before the crisis was its “comply or explain” principle, now a key feature of the EU approach to governance.⁴⁴² A flexible alternative to detailed regulation, the principle underpins non-binding rules or recommendations found in members' corporate governance codes.⁴⁴³

Interestingly, the Forum took the position that the 'comply-or-explain principle should be enforced by Member States as a mandatory norm of conduct either through their corporate law or regulatory authority, but that regulators should limit their role to verifying the existence of the disclosure while deferring to the business judgement of directors with respect to its content and the prerogative of shareholders to enforce the disclosure's quality.⁴⁴⁴ The Forum's ongoing role in ECGR has impacted the German Corporate Governance Code (“GCGC”) and legislative initiatives in German corporate governance.

Developed in 2002 by the German Government Commission the GCGC contains “essential statutory regulations for the management and supervision (governance) of German listed companies [and] internationally and nationally recognized standards for good and responsible governance [and] aims at making the German corporate governance system transparent and understandable [and] promotes the trust of international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations.”⁴⁴⁵ Most of the rules are not legally binding, but companies who do not comply must publicly disclose “how and why their practices differ from those recommended by the Code.”⁴⁴⁶

The GCGC has six main components: 1) the shareholders and general meeting; 2) the cooperation of the Management Board and Supervisory Board; 3) tasks and responsibilities of the Management Board; 4) tasks and responsibilities of the Supervisory Board; 5) transparency

⁴⁴¹ European Commission, “European Corporate Governance Forum: Overview” *EC* (2011), Online, EC, <http://ec.europa.eu/internal_market/company/ecgforum/index_en.htm>.

⁴⁴² European Commission, Statement of the European Corporate Governance Forum on the comply-or explain principle *EC* (2006), Online: EC, <http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf>.

⁴⁴³ *Ibid.*

⁴⁴⁴ *Ibid.*

⁴⁴⁵ German Government Commission, “German Corporate Governance Code” *European Corporate Governance Institute* (26 May 2010), Online: ECGI, <http://www.ecgi.org/codes/documents/cg_code_germany_may2010_en.pdf>.

⁴⁴⁶ SLG Group-The Carbon Company, “Fundamentals of Corporate German Corporate Governance” *SLG Group* (undated), Online: SLG Group, <http://www.slggroup.com/cms/international/investor-relations/corporate-governance/principles-of-german-corporate-governance/index.html?_locale=en>.

and; 6) accounting and auditing of annual financial statements.⁴⁴⁷ Key developments in the GCGC include changes to the shareholders' annual general meeting and to the Management Board's remuneration in 2006.⁴⁴⁸ The latter reflects amendments made to Management Board compensation under the German Board Member Monetary Compensation Disclosure Act "VorstOG".⁴⁴⁹

Pertaining to enhanced disclosure requirements for Management Board pay, the VorstOG resulted from a heated debate over the policy goals served by requiring such disclosure.⁴⁵⁰ The major change effected by this provision was to require the publication of Management Board members' individual salaries as opposed to mere disclosure of total pay to the shareholders. Also worthy of mention is the 2005 relaxing of the business judgement rule to better insulate directors for decisions with respect to increasing company performance and taking additional risk.⁴⁵¹ The ten-point program in the UMAG amends the German Stock Corporations Act in several respects. Under the first point, management decisions will no longer constitute a breach of directors' duties where the Board member "reasonably believes that he acted for the good of the company and if his decision was based on appropriate information."⁴⁵²

II. The EU Takeover Directive

Of notable importance to the broader story surrounding executive pay in Germany was the process leading up to the EU Takeover Directive's defeat. Unfolding contemporaneously with the Mannesmann ordeal during a tumultuous period for German corporate governance, this regulatory contest exemplifies the politics of corporate governance liberalization in the decade preceding the crisis. Characterized as a "broad political backlash led by managerial and labour interests against the adoption of Anglo-American shareholder capitalism" the directive's defeat can be viewed as a push-back against concessions made to neo-liberal trends under the Control and Transparency Act "KonTraG" which rendered German firms more vulnerable to hostile

⁴⁴⁷ *Ibid.*

⁴⁴⁸ Rudiger Von Rosen, "Corporate Governance in Germany" (2007) 15 (1) *Journal of Financial Regulation and Compliance* 30.

⁴⁴⁹ *Ibid.*

⁴⁵⁰ *Ibid.*

⁴⁵¹ DSW, "German Corporate Governance and the Law" *Deutsche Schutzvereinigung für Wertpapierbesitz* (2010), Online: <DSW, <http://www.dsw-info.de/German-Corporate-Governance-an.594.0.html>>.

⁴⁵² *Ibid.*

takeovers.⁴⁵³ The simultaneous unfolding of the Mannesmann ordeal can be viewed as a parallel narrative characterized by a push-back by Mannesmann prosecutors against the infiltration of liberal market pay norms into Germany Inc.'s corporate culture. Professor John Cioffi states the following in response to the defeat of the Commission's 13th Directive on Takeover Bids:

“The draft Directive was the clearest and most far-reaching attempt to introduce Anglo-American concepts of shareholder value, and shareholder capitalism generally, into the European political economy. And for this reason, the Directive became one of the most divisive pieces of legislation to ever come before the European Parliament, sparking fierce opposition and unusual alliances that reveal the substantial social and political differences between Anglo-American neo-liberalism and the legacies of Continental statist and corporatist political economic institutions.”⁴⁵⁴

Tensions between a broader EU-driven integration into competitive global markets and the embedded capitalisms of EU member states are deeply implicated in these processes. Germany's experience with the EU Takeover Directive, viewed as regulatory reflex to earlier pressures to liberalize its corporate governance regime, is a telling example of these tensions at play. Likewise, the unfolding of the executive pay debate in Germany leading up to the crisis tells a parallel story and provides a background against which to assess post-crisis reforms.

III. The Mannesmann Ordeal

The Mannesmann ordeal illustrates a friction between Germany Inc.'s corporate culture and shareholder-centric pay practices which reward management exclusively for serving shareholder interests.⁴⁵⁵ Prosecutors in an unprecedented move resorted to using Germany's criminal code to sanction the approval of excessive compensation, typically dealt with under s. 87 of the German Stock Corporations Act, the *Aktiengesetz* (AktG), as a breach of fiduciary duties. In response to Supervisory Board directors approving unusually large bonuses for the Chief Executive's role in facilitating a takeover, prosecutors alleged that five supervisory board directors and one executive “breached their duty to the broader interests of the company, which

⁴⁵³ John Cioffi, “The Collapse of the European Union Directive on Corporate Takeovers: The EU, National Politics, and the Limits of Integration” *Discussion Paper, Berkeley Roundtable on the International Economy* (23 September 2001), Online: Berkeley, <<http://brie.berkeley.edu/publications/John%20Cioffi's%20paper.pdf>>; See also John Cioffi, “Restructuring “Germany Inc.” The Politics of Company and Takeover Law Reform in Germany and the European Union” (2002) 24 *Law & Policy* 355.

⁴⁵⁴ *Ibid.*

⁴⁵⁵ European Industrial Relations Observatory, “Vodafone's hostile takeover for Mannesmann highlights debate on the German capitalist model” *EurWORK Observatory* (28 November 1999), Online: EurWORK, <<http://www.eurofound.europa.eu/eiro/1999/11/feature/de9911220f.htm>> (noting that workers were afraid of lay-offs and a failure of the company's new owners to embrace Co-determination as a consequence of rewarding managers to facilitate the takeover.); See also Peter Kolla *supra* note 436.

consequently damaged the company”.⁴⁵⁶

Prosecutors alleged a criminal breach of fiduciary duty, carrying a maximum sentence of ten years. Some have commented that despite condemning the size of the bonus payments awarded, prosecutors were more concerned with sanctioning the use of Anglo-American style pay incentives designed to reward short-term price appreciation.⁴⁵⁷ While the outcome of the trial resulted in the acquittal of all six defendants for criminal wrongdoing, the judge concluded that the bonuses awarded to outgoing executives were inappropriate and violated Germany’s stock law governing executive compensation.⁴⁵⁸

In determining whether the accused managers committed “a criminal breach of duty to manage the assets of another” the German Federal Court looked to section 87(1) as a guideline to determine whether the bonus awards constituted a misappropriation of the company’s assets and fixed reserves.⁴⁵⁹ Absent a clear standard under s.87 for determining a breach of fiduciary duties in the remuneration context, the Court was unable to overcome the burden of proving a criminal breach, leading to the 2006 acquittal of all defendants.⁴⁶⁰

The accused managers had argued the awards were justifiable in light of the staggering wealth created by management's facilitation of the takeover. While the awards totaled an unprecedented 50 Million Euros, over 50 Billion Euros had been created for shareholders, many of which were foreign entities integrated into capital markets outside of Germany. In doing so, they repudiated Germany's model of stakeholder capitalism in favor of a shareholder value norm. The Court found however, that the awards failed to benefit the corporation first despite the gains created for shareholders and held them as falling below the standard set out in the AktG.

⁴⁵⁶ Kolla, *supra* note 436.

⁴⁵⁷ Kolla, *supra* note 436 (Noting that defence lawyers commented during the trial that “the prosecutors are making clear they don’t want this type of remuneration to become commonplace...they want to use the *untreue* law to hold it in check”); See also pg. 845 (“turning to the Mannesmann trial, theoretically there are two possible clear outcomes...either Germany will tolerate large executive payments typical in Anglo-American economies, or they will reject them as criminal.”)

⁴⁵⁸ See Patrick Jenkins, “Mannesmann Verdict Leaves Questions” (1 April 2004) FINANCIAL TIMES [US EDITION]; See Kolla, *supra* note 436 at 843-844.

⁴⁵⁹ See Maier, *supra* note 436; See also Bundesministerium Der Justiz, *German Criminal Code (Strafgesetzbuch)*, 1998, s. 266 (section 266 states that “whosoever abuses the right accorded him by law, official instruction or legal transaction to manage the property of a third party, or violates the duty entrusted [to] him by law, official instruction or legal transaction to safeguard the property of a third party and thereby disadvantages whomsoever's property interests had been entrusted to him, shall be imprisoned for up to five years or fined”).

⁴⁶⁰ Kolla, *supra* note 436 at 834; See also A key factor in determining legality was whether the bonuses conformed to section 87(1) of Germany’s Stock Corporations Act (AktG) which stated at the time, that executive compensation must be appropriate in relation to the tasks of the executive and the state of the company. See *AktG*, s. 87(1)

Despite the vagueness of s.87 for determining the appropriateness of the bonus awards, the prosecution argued for an interpretation based on Germany's broader context of stakeholder capitalism, which the judge eventually accepted, though the criminal threshold had not been breached. It became clear during the trial to commentators that prosecutors were attempting to serve the broader goal of deterring large executive bonuses that threatened to create improper incentives for management in Germany to maximize short-term shareholder value.⁴⁶¹ These sentiments, however, did not crystallize into binding norms until after the financial crisis.

IV. The Commission's Pre-Crisis Remuneration Initiatives

While much of the business and legal community in Germany and abroad awaited the final Mannesmann verdict, the Commission released its 2004 recommendations on director remuneration. Focusing mainly on disclosure and shareholders rights, it represented a continued push towards aligning shareholder and manager interests, a development resisted in the Mannesmann debate. The recommendations, which were subsequently adopted, set-out guidelines for disclosure and shareholder control with respect to director remuneration.⁴⁶² The Internal Market Commissioner recognized the conflict in executive directors setting their own pay. At the time, this initiative was consistent with US developments in corporate legal scholarship, namely the debut of the managerial power approach, outlining this same phenomenon.⁴⁶³ The Commissioner further recognized that shareholders should be better informed and able to ensure that sufficient incentives exist for directors through proper disclosure and effective control rights. However, the initiative focused on providing guidance to Member States on implementing such soft or hard law provisions supporting greater shareholder involvement.⁴⁶⁴

Tensions between the role of corporate and capital market law on the one hand and the competing interests of labour and finance on the other are less visible in this thread of corporate governance norm generation aimed largely at standardizing disclosure practices and investor

⁴⁶¹ The Economist, "Fall-Out from Mannesmann: Breach of Trust?" *The Economist* (20 February 2003), Online: Economist, <<http://www.economist.com/node/1760645>>.

⁴⁶² European Commission, "COMMISSION RECOMMENDATION of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies" *EC* (Dec 29, 2004), Online: EC, <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0055:0059:EN:PDF>>.

⁴⁶³ European Commission, "Press Release: Directors' pay – Commission sets out guidance on disclosure and shareholder control" *EC* (Oct 6, 2004), Online: EC, <http://europa.eu/rapid/press-release_IP-04-1183_en.htm?locale=en>.

⁴⁶⁴ *Ibid.*

rights across the EU. This initiative seems to highlight the frictions instead between managers and investors in a push to bolster and restore confidence to European markets.⁴⁶⁵

However, in the background of these multilevel consultations, exists visible threads of a debate over the size and subsequent fairness of executive compensation. The eventual unfolding of the Mannesmann verdict in 2006 amplifies these tensions between the need to harmonize executive pay levels in a manner compatible to the liberal market dynamics of ECGR on the one hand and Germany's embedded system of capitalism and concomitant corporate culture on the other.

These concurrent developments concerning executive pay in Germany bring these tensions into sharper relief by pitting the need to create sufficient incentives for shareholders on the one hand, against the need to keep executive pay reasonably in-line with labour's sensitivities over the distribution of corporate wealth in society on the other. The point where pressures to adopt a liberal market approach to executive remuneration appear to converge in the Mannesmann ordeal, is the ambiguously worded s. 87 of the German Stock Corporations Act in its previous format, a weak-point in Germany's corporate-legal matrix which allegedly placed Germany's entire system of embedded capitalism on trial.

V. The Exposure of German Banks to the Crisis

Given these developments at the European level to ensure that directors are adequately incentivized to perform in the context of a need to restore confidence to European markets, it is not surprising that German banks were exposed to and implicated in some of the risky transactions which led to the crisis. This was likely contributed to by the fact that a rejection of the liberalization trend in Mannesmann failed to crystallize into governance norms until after the crisis, when the ambiguity in s. 87 AktG was eventually clarified in the VorstAG.

Despite the origins of the crisis being in the US, German legislators were concerned over the exposure of German banks to its effects. It became apparent early on that German banks had engaged in risky strategies and failed to assess the risks associated with their investments in US toxic assets. According to Kaal and Painter, some of Germany's largest banks “made these investments through special purpose entities and other conduits in foreign jurisdictions that held

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Ibid.

CDOs and other long-term mortgage loans that had been financed with the proceeds of short-term financed Asset Backed Commercial Paper (ABCP) and Asset Backed Securities (ABS).”⁴⁶⁶

Because of the complexity of these investments, many fell outside the jurisdiction of the German banking regulators but came apparent when the market for CDOs collapsed.⁴⁶⁷ Such unprecedented exposure to risk by German banks prompted regulators to implement comparatively harsher reforms against risk-taking not only in the banking sector but also in the governance of large public corporations.

VI. The Commission's Post-Crisis Remuneration Initiatives

In 2009, both the European Commission and the FSF developed a set of recommendations on executive remuneration in the financial sector in response to Financial Crisis.⁴⁶⁸ The Internal Market Commissioner recognizes the prevalence of perverse incentives in the financial industry leading up to the crisis and their role in encouraging excessive risk-taking.⁴⁶⁹ In this case, the Commission has accepted the FSF's principles on remuneration and is taking the lead on their implementation.⁴⁷⁰ Interestingly, while the need to maintain performance based incentives is recognized, the need to constrain such incentives in line with long-term sustainable performance and sound risk management is the dominant feature of this approach.⁴⁷¹

The ECGF also set-out its recommendations on executive remuneration in the wake of the crisis.⁴⁷² Articulated as a set of best practices that should govern the remuneration of executive directors going forward, the ECGF released the following principles:⁴⁷³

⁴⁶⁶ See Kaal and Painter *supra* note 135.

⁴⁶⁷ *Ibid.*

⁴⁶⁸ European Commission, “COMMISSION RECOMMENDATION on remuneration policies in the financial services sector” *EC* (Apr 29, 2009), Online: EC, <http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf>.

⁴⁶⁹ European Commission, “Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions” *EC* (Apr 29, 2009), Online: EC, <http://europa.eu/rapid/press-release_IP-09-674_en.htm?locale=en>.

⁴⁷⁰ *Ibid.*

⁴⁷¹ *Ibid.*

⁴⁷² EUCGF, “Statement of the European Corporate Governance Forum on Director Remuneration” *EUCGF* (23 March 2009), Online: EU, <http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-remuneration_en.pdf>.

⁴⁷³ *Ibid.*

1. The level of variable pay (typically with both a short term and a long term element) should be reasonable in relation to total pay level. Generally, the larger the variable pay element is, the stronger the focus on the beneficiary's personal interests becomes, to the possible detriment of the long term interests of the company and its shareholders. Companies should develop a clear policy on variable pay, within the remuneration policy subject to approval by shareholders. That policy should set maximum limits on all elements of variable pay.
2. Variable pay should be linked to factors that represent real growth of the company and real creation of wealth for the company and its shareholders. The factors to be taken into account for variable pay should be independently reviewed by non-executive directors.
3. In order to reduce the short term focus of variable pay, companies should consider deferring a substantial part of annual bonus payments to be released subject to continuing positive performance by the company over a period of, say two to four years.
4. Stock options (rights to acquire shares for a pre-determined exercise price) carry an increased risk of market manipulation and gaming as the upside potential is leveraged. These risks can be mitigated if vesting of the options is deferred and subject to performance conditions. Underperformed stock options should be excluded from the remuneration policy.
5. Shares granted to executive directors under long term incentive plans should vest only after a period during which performance conditions are met. At least a certain number of those shares as determined by the non-executive directors (e.g. two times the value of total annual pay) should be held by directors until the end of their employment, with the exception of such part of those shares that need to be sold in order to be able to pay taxes due as a result of the grant of shares.
6. To the extent possible under applicable employment laws and companies' legislation, the company should reserve the right, at the discretion of non-executive directors, to reclaim performance linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice.
7. Severance pay for executive directors should be restricted to two years of annual remuneration and should not be paid if the termination is for poor performance. The two years restriction should not be circumvented by long notice periods or otherwise.
8. Entitlements should be fully disclosed and discretionary increases for departing executives should be avoided. Any benefit in kind should also be part of the remuneration package and should be fully disclosed.
9. Benchmarking the remuneration of executive directors with the remuneration of directors of companies in a peer group, combined with the practice of aiming to reward directors at the median or upper quartile of such peer group, creates an autonomous upward pressure ("ratchet effect") on the remuneration of directors of all companies which has no relation

to underlying performance of these companies or personal performance of directors. Non-executive directors should not only benchmark the remuneration of executive directors externally with peers but should also benchmark their remuneration internally with the remuneration of other employees within the company in order to ensure a consistent and fair remuneration policy throughout the company.

10. Non-executive directors should have and exercise discretion to change the actual remuneration calculated on the basis of formulae, targets and benchmarks in order to ensure that the total pay executive directors receive is fair in relation to the company's and their personal performance and not excessive. Any adjustment to the operation of established remuneration schemes should be fully disclosed.

SECTION B: The German Response to Compensation Reform

In the wake of the financial crisis, the German government enacted new legislation on the appropriateness of Management Board compensation, clarifying the role of existing law in a manner consistent with the court's interpretation in *Mannesmann*. The new *Act regarding the Appropriateness of Management Board Remuneration* ("VorstAG"),⁴⁷⁴ imposes amendments to the *German Stock Corporations Act* ("AktG"),⁴⁷⁵ which directly impact the fiduciary duties of Supervisory Board directors.⁴⁷⁶ The following sections are amended:

- Section 87 Subsection 1 *AktG*
- Section 87 Subsection 2 *AktG*
- Section 193 Subsection 2 Clause 4 *AktG*
- Section 116 *AktG*
- Section 107 Subsection 3 Clause 3 *AktG*
- Section 100 Subsection 2 Clause 1 No. 4 *AktG*
- Section 93 Subsection 2 Clause 3 *AktG*

⁴⁷⁴ Bundesministerium Der Justiz, *Act on the Appropriateness of Management Board Compensation (VorstAG)*, 2009.

⁴⁷⁵ Bundesministerium Der Justiz, *German Stock Corporations Act (AktG)*, 1965.

⁴⁷⁶ Ralf Ek, "Germany: New Developments in Management Board Compensation" *Jones Day* (30 November 2010), Online: Mondaq,

<<http://www.mondaq.com/x/116734/Directors+Officers/New+Developments+in+Management+Board+Compensation>>.

("On August 5, 2009, the German Act on the Appropriateness of Management Board Compensation became effective. This legislative amendment has had such a major impact that most stock corporations are currently reviewing their compensation systems. A mandatory adjustment obligation exists in case new employment contracts for management board members are concluded. Moreover, listed stock corporations must consider the recommendations of the German Corporate Governance Code, particularly with a view to caps on severance pay.")

These amendments result in stricter obligations for directors to implement compensation that is appropriate in size and aligns the interests of the Management Board with the long-term interests of the corporation and its stakeholders.⁴⁷⁷ The Act has 6 key features which impact how the Supervisory Board sets the Management Board's remuneration:

- Limits on remuneration and the requirement to assess
- Remuneration structure to promote sustainable development of company
- Requirement to reduce remuneration when situation of company deteriorates
- Increased liability for approving inappropriate remuneration
- Cooling-off period for executives to serve on Supervisory Board
- Enhanced disclosure requirements

SECTION C: Limitations on Remuneration and the Requirement to Assess

By imposing limits onto executive compensation 87(1) 1 AktG in its amended form constrains the discretion and business judgment of Supervisory Board directors, making the implementation of excessive pay and short-term incentives less feasible. More specifically this provision requires executive pay to bear a relationship to executive responsibilities and a company's performance.⁴⁷⁸ Section 87(1) 1 *AktG* now states:

When fixing the total remuneration of an individual management board member (salary, profit participation, expense allowances, insurance premiums, commissions, incentive-based remuneration commitments like...stock options and fringe benefits of any kind), the supervisory board shall make sure that the remuneration is in adequate proportion to the duties and responsibilities and the performance of the management board member as well as to the situation of the company and does not exceed the customary remuneration without particular reasons.

This amended version increases the Supervisory Board's obligation to assess the appropriateness of executive remuneration. This includes an obligation to examine comparable environments such as the company's size, industry norms and wage levels within the company including those of front-line employees.

⁴⁷⁷ VorstAG, *supra* note 475.

⁴⁷⁸ Kolla, *supra* note 436.

SECTION D: Remuneration Structure to Promote Sustainable Development of Company

Through these constraints on discretion, directors are restricted to creating particular incentives for management that better align their interests with the best interests of the corporation. Section 87(1) 2 now states:

“The remuneration structure for listed stock corporations shall be geared towards a sustainable development of the company. Variable components of the remuneration shall therefore be based on a perennial assessment; the supervisory board shall agree on means of limitation in case of extraordinary developments.”

This provision creates an obligation for Supervisory Board directors to adjust compensation incentives in line with the company's development based on several years of assessment data. Section 93(2) 4 AktG as amended by VorstAG goes a step further by requiring Supervisory Board Directors to place a 4 year limit on the exercise of their stock options. Section 87(2) in its amended form also requires the Supervisory Board to limit pay if extreme developments arise. This refers to large rises in the company's share price from events such as a takeover or an upwards market trend that might spur extreme demands from managers for increased levels of pay. This addresses the events that transpired in Mannesmann where Supervisor Board directors felt justified in paying the Management Board unprecedented bonuses based on the company's overnight share value appreciation.

The general assembly of shareholders can approve the remuneration structure by issuing a non-binding declaration of their opinion. This right to vote remains non-binding for two substantial reasons. One is to prevent shareholders from limiting the liability of directors by shifting decision making power away from the Board. Two is to avoid situations in which shareholders might approve compensation that serves their interests but is not compliant with statutory norms. This relates more directly to foreign investors of large public companies in Germany, who might have shorter investment horizons than ‘patient capital’ in Germany.

SECTION E: Requirement to Reduce Remuneration When Situation of Company Deteriorates

Despite having a similar function, this provision is not a claw-back provision for remuneration earned from the fraudulent misrepresentation of earnings. It relates instead to the state of the company as measured through various indicators. In the past if there was substantial decline in the corporation's state the Supervisory Board was required to reduce the Management Board's pay if continuing at existing levels was grossly unfair to the corporation. The company's economic difficulties did not justify a reduction if management acted in good faith under the business judgment rule. They now have an enhanced responsibility to reduce pay if the corporation is distressed. Continued payment at the existing level does not have to be grossly unfair nor does the reduction have to be based on a substantial decline in the company's situation.

Indicators of a decline include reductions in employee wages, terminations or layoffs of the workforce, inability of the company to distribute profits and a crisis or insolvency. While the latter will always require reduction, there is no order of priority for the other criteria. Thus, if the company's market price is high but substantial lay-offs are required, the obligation could be triggered. This statutory provision is mandatory and amounts to a legal obligation for the Supervisory Board. It also supersedes the employment contract, but allows affected Management Board members to terminate the contract with notice.

SECTION F: Increased Liability for Approving Inappropriately High Remuneration

While sections 116 AktG and 93 AktG already make the Supervisory Board liable for breach of obligations, including inappropriately high pay, section 116 AktG now includes explicit liability for inappropriate pay, which is emphasized as a most important duty. Members who breach the duty to pay appropriately are personally liable. Section 93 AktG increases the effects of this liability on Supervisory Board directors by mandating a deductible of at least 10% on directors' liability insurance, creating a stronger incentive to comply. According to the amended version of section 107(3) 3 AktG the Board can no longer delegate new employment agreements to a committee including decisions on the structure and size of the remuneration. The entire plenum of the Supervisory Board has an obligation to determine and continually adjust the Management Board's compensation.

SECTION G: Cooling-off period for executives to serve on Supervisory Board

Section 100(2) 1 (4) AktG creates a restriction on the ability of former Management Board members to sit on the Supervisory Board. The amended provision imposes a two-year cooling-off period for Management Board members seeking a position on the company's Supervisory Board after serving their term.

SECTION H: Enhanced disclosure requirements

Supervisory Board members are now required to disclose in greater detail, an executive directors' compensation scheme. They must explain how the compensation structure creates incentives for sustainable firm performance and how they have complied with appropriateness requirements. Moreover, if the compensation exceeds customary levels, the Supervisory Board is required to explain and justify why this is required.

SECTION I: Analysis

1. Does the provision represent a new behavioral norm for directors requiring additional due diligence, a consideration of new circumstances or the following of new procedures when setting or approving compensation?

The legislation in its entirety represents new behavioral norms for directors as well as the enhancement of existing norms of conduct. While the Supervisory Board was previously required under section 87(1) to set the appropriate level of remuneration based on the duties and performance of the Management Board member, the provision was overbroad. Subsection 87(1) was originally meant to be interpreted in a stakeholder-based context, but provided no guidance as to what constitutes an appropriate value on executive labor or how to reconcile the state of the company with shareholder interests.⁴⁷⁹ While shareholder interests are meant to be aligned with those of the corporation, there was previously no distinction between short and long-term. Courts in Germany arguably interpret these provisions in the context of fairer wealth distribution between stakeholders and the absence of a shareholder value norm.⁴⁸⁰ The lack of a clear distinction between rewarding short-term or long-term profit proved to be particularly problematic in *Mannesmann* where the defendant's argued for an interpretation based on shareholder primacy to justify the payments made.⁴⁸¹

The standard established by the German Federal Court (BGH) in *Mannesmann*⁴⁸² and the amendment to 87(1) of the AktG clarifies the standard by which directors must measure performance and the correct context for interpreting the appropriateness of pay. By specifying

⁴⁷⁹ See Economist, *supra* note 462.

⁴⁸⁰ The German Federal Court (BGH) in the Mannesmann trial interpreted section 87(1) par. 1 of the AktG in line with the values of Germany's stakeholder model in that the remuneration of an executive's contribution to the firm was supposed to be fair in comparison to how a worker's contribution is valued and appropriate in relation to how executives contribute to the firm's ongoing success. This implies that the firm's long-term success must be put before short-term gains. See Bauer, *supra* note 370 (noting that it was clarified by the BGH that incentives arising from executive compensation should always benefit the company and should never damage the company in the long-run. The court indicated that a breach of fiduciary occurs when appreciation awards fail to benefit the company. "In the Mannesmann ruling the BGH held generally that the Supervisory Board must always act in the interests of the company. It is obliged to preserve acquired benefits and avert damage to the company. This obligation also affects the approval of appreciation awards to management board members"), ("with regards to the criminal responsibility of the accused supervisory board members, the BGH held that the approval of appreciation awards that do not benefit the company also constitutes a criminal breach of fiduciary duties".)

⁴⁸¹ See Economist, *supra* note 462.

⁴⁸² Bauer, *supra* note 436 (Noting that the BGH concluded that appreciation awards of the type granted are only admissible if the company first and foremost receives a benefit in return).

that “the remuneration structure for listed stock corporations shall be geared towards a sustainable development of the company”⁴⁸³ the provisions instruct the Supervisory Board to correlate executive compensation with long-term development.

This also equates the best interests of the corporation to its long-term interests and the standard set is that Management Board compensation cannot be so excessive as to promote unsustainable management practices.⁴⁸⁴ This limits the extent to which directors can equate the state of the company with its short-term share value when setting executive pay, representing a narrowing of the business judgment rule in this area.

2. Is it mandatory or enabling? Does it impose extra-economic or efficiency based norms of conduct? Does it require directors to account for how executive pay impacts the corporate entity or to engage predominantly in arm’s length bargaining?

Several aspects of this legislation are mandatory legal norms of behavior that are extra-economic or non-market-based and require directors to account for the substantive effects of executive pay on the corporate entity as opposed to engaging in arm’s length bargaining on behalf of shareholders. The entire Supervisory Board is now responsible for ensuring an appropriate size and structure of executive compensation. It clarifies and expands their fiduciary duties. They face liability for 1) the size of pay being inappropriate, 2) for not reducing pay if the situation of the company deteriorates and 3) for not reducing pay in the case of extraordinary developments in the company’s share price.

In situations where directors are obligated to reduce pay or to approve appropriate levels in the first place, liability is triggered when the size of pay amounts to a mismanagement of the corporation’s assets. In this case, directors are personally liable to repay the compensation and are limited by statute from seeking a low deductible for D & O insurance. The enhanced duties of directors are extra-economic in nature and are premised on principles of loyalty towards the entity and proper stewardship of its assets. These duties are not discharged and do not fall outside the scope of scrutiny if performance is high in relation to compensation.

⁴⁸³ Ek, *supra* note 477.

⁴⁸⁴ Given the background of the financial crisis and the criticism of traditional payment systems for top managers, the German legislative body tried to introduce a tool that would guide directors’ and officers’ remuneration and introduce a compensation structure that promotes long-term company development.

While the term “shall” implies that directors are obligated to create long-term incentives geared towards sustainable firm development, liability in the case of failed risk or improper short-term incentives would be difficult to establish, especially where significant time has elapsed and the cause of a negative future development is uncertain. While the structure of a company’s incentive plan might appear to be short-term oriented, liability cannot be incurred *ex ante*.

Inappropriate incentives must be attributed to future loss or damage to the company. As discussed, the provision sets out various criteria for directors to consider when determining the appropriateness of pay. Directors are not liable for failing to consider each and every criterion individually or for improperly weighing one against the other. This range of discretion remains protected under the business judgment rule. However, directors are expected to act reasonably in the circumstances.

3. Is the effect of the provision such that it results in the interests of other stakeholders being taken into account by directors when setting executive pay and does it result in directors prioritizing the corporation over immediate shareholder returns?

The provision relates the appropriateness of executive compensation to the tasks, duties and responsibilities performed by the Management Board. As a result, it imposes a limit onto how high an executive’s labor can ultimately be valued. Although, the wording is not explicit as to what an appropriate limit might be on the remuneration of a particular managerial task, the fact that the law equates the value of an executive’s labor with the complexity of the task performed⁴⁸⁵ implies that the market is not the ultimate determinant of how executive labor is valued.

⁴⁸⁵ Freshfields Bruckhaus Deringer LLP, “Germany Introduces New Rules on Management Board Compensation” *Freshfields Briefing* (August 2009), Online: Freshfields, <http://m.freshfields.com/uploadedFiles/SiteWide/Knowledge/Germany%20introduces%20new%20rules_26499.pdf>. See also Ek, *supra* note 477.

By denoting that executive pay must be appropriate “in relation to the tasks performed” or “in adequate proportion to the duties and responsibilities and [to] the performance of the management board member” this provision acknowledges that the value of a particular task or contribution has a maximum limit, beyond which it can no longer be justified by increases in the company’s share price. From a viewpoint of substantive fairness, an executive’s pay structure under these circumstances is a fairer reflection of their actual contributions to the firm and not merely a reflection of what shareholders are willing to pay for sharp increases in short-term performance.⁴⁸⁶

Section 87(1) 1 states that Supervisory Board directors have the duty to ensure that executive pay “does not exceed the customary remuneration without particular reasons.”⁴⁸⁷ The term “customary remuneration” in this case refers to the level accepted throughout the industry for similar tasks, duties and responsibilities.⁴⁸⁸ Although not quantified, the existence of such a level implies that the maximum amount of executive pay is restricted to what the corporate culture deems as being acceptable which is relative to worker pay and the distribution of societal wealth either regionally or nationally.⁴⁸⁹

The criteria for assessing the appropriateness of executive compensation reflect the interests of labor, creditors and long-term shareholders. By relying on these criteria, directors are prompted to contemplate whether the size of executive compensation is such that it will undermine worker morale and the willingness of workers to make wage concessions during

⁴⁸⁶ See Ronald Dore, “Comment: Paper on Employees and Corporate Governance” (2000) 22 *COMP LAB L & POL’Y J.* 159 (argues that the debate over executive pay actually debates normative questions of social justice in respect to the equitable compensation of one’s contribution to the firm.)

⁴⁸⁷ Ek, *supra* note 477.

⁴⁸⁸ See Freshfields, *supra* note 486 (Noting that “according to the legislative material, one must look to the branch, size and country to determine what remuneration would be customary...furthermore, the salaries paid within the company must be considered...thus the supervisory board has to make sure that the remuneration of the management board members remains in proportion to the remuneration system within the company.”) See also Ek, *supra* note 477 (noting that “The appropriateness of the total remuneration of the individual management board members is therefore based on the member’s duties, responsibilities, and performance, as well as on the situation of the company. Furthermore, the remuneration of the individual members must not exceed the remuneration customary in the industry or country without particular reasons...When fixing the management board compensation, the supervisory board must ensure that such compensation is on a level with that of companies of the same trade with comparable size and complexity, but it should also take into account the particular salary and wage structure within the company. In addition, the supervisory board must consider what salary is deemed “customary” within the statute’s area of application.”)

⁴⁸⁹ Ek, *ibid.*

economically difficult periods. Directors have an interest in considering these factors because they impact the corporation's ability to operate sustainably. Labor unrest and dissatisfaction with wages and working conditions impact operations. German industrial firms are sensitive to this because employees are highly skilled, trained extensively by their companies at high cost, and possess firm specific skills.

Placing substantive limits on executive compensation through criteria other than share price limits the extent to which executive compensation can be linked to the capital market. Large bonuses that reward sharp increases in profitability become less feasible.⁴⁹⁰ This is further reinforced by the Supervisory Board's obligation to limit the size compensation in the case of extraordinary developments stemming from market events. The extent to which executives are incentivized to take measures that maximize profits at the expense of worker's interests or without considering the firm's future well-being is reduced.

4. Is the effect of the provision such that directors utilize performance criteria other than share price to gauge whether executive compensation schemes are acceptable?

The requirement that the total amount of remuneration to appropriately reflect the state or situation of the company sets out a different standard for measuring performance than what is used by Anglo-American directors. Corporate directors in the U.S. have no explicit legal constraints on how they should correlate firm performance with executive pay and as a result rely on their business judgment to determine which pay incentives are in the best interests of the corporation. This usually amounts to short-term performance criteria.

By denoting that executive compensation must be kept in appropriate relation to the state or situation of the firm, this part of the provision limits the extent to which performance can be correlated to short-term profit or share value, further weakening the relationship between executive compensation and share price. Section 87 (1) 1 in effect instructs directors to prioritize the state of the firm over the short-term interests of shareholders, ensuring a consistent outcome

⁴⁹⁰ See Freshfields, *supra* note 486 (Noting that the Supervisory Board, in setting variable executive remuneration shall include a cap on the maximum allowable remuneration to limit the possibility of extraordinary developments such as large increases in share price. The objective of such a cap is to ensure that the Management does not profit from extraordinary developments such as takeovers, the sale of assets or the realization of hidden reserves.)

in the incentives created for management.⁴⁹¹ This restricts the Supervisory Board's ability to implement excessive bonuses that incentivize executives to focus exclusively on profits, resulting in moderate compensation levels correlated to the well-being of the firm itself.⁴⁹²

CHAPTER TWELVE:

Assessing the Current Approach to Compensation Reform

Here we assess our initial questions asked about executive pay in 1.10 and whether the goals of compensation reform identified can be achieved from within the confines of optimal contracting and shareholder primacy or whether effective compensation reform entails a repudiation of certain aspects of these models and a greater focus on and use of stakeholder-based norms through corporate law. The following two questions were asked:

1. Should managerial power in the firm be predominantly defined as a lack of performance and does attempting to constrain managerial power through performance-based norms of conduct exacerbate its outwards effects?
2. Can excessive risk-taking and short-term profit-seeking be effectively constrained by adjusting the structure of executive compensation to better align shareholder and manager interests without changing the existing level of directors' discretion and exposure to capital market pressures?

⁴⁹¹ See Bauer, *supra* note 436 (noting that "In the Mannesmann ruling the BHG held generally that the Supervisory Board must always act in the interests of the company. It is obliged to preserve acquired benefits and avert damage to the company. This obligation also affects the approval of appreciation awards to management board members. The BHG stated that the level of management remuneration must be in proportion to a management board member's responsibilities and the company's performance subject to section 87 AktG.")

⁴⁹² See Max Phillip Rolshoven, "The Last Word? - The July 22, 2004 Acquittals in the Mannesmann Trial" (2004) 5(8) *German Law Journal* 939 (noting that the German Federal Court in Mannesmann reiterated that the issuance of executive pay must be correlated with the interests of the firm. Citing that in the Mannesmann trial "the [bonus] payments nevertheless were found [by the Court] to violate the German stock corporation law, because they did not, according to the Court, lie in the firm's, i.e. Mannesmann's, interest.")

I. Answer to Question 1

Conceptualizing the problem of managerial power in the firm strictly in terms of agency costs and then employing compensation incentives as a mechanism for controlling these costs is geared towards diverting a higher level of profit to the shareholder by incentivizing managers to create new efficiencies in the firm. In fact, agency costs are synonymous in the literature with sub-standard share price performance, inadequate risk-taking and the use of directorial discretion to consider other interests which might benefit the firm in the long-run or represent a socially responsible use of the corporation's resources. Constraining managerial power as defined in such narrow terms benefits a particular set of constituents in the firm, the executive and the short-term shareholder by raising the corporation's market value. What is not so obvious from the confines of the optimal contracting paradigm is that if taken too far, it can do so at the expense of other constituents, including shareholders' own long-term interests.

Compensation incentives as opposed to being a comprehensive solution to the managerial power problem geared towards producing an outcome which benefits and enhances the corporation, instead shifts how the costs and benefits of managerial power are distributed and harnesses managerial power to a particular end. Other aspects of managerial power remain unaddressed. The propensity of managers to extract excessive rent from the corporation, interfere with and undermine the checks and balances designed to constrain their behaviour, harm the firm in order to favour the interests of a particular constituent, or oppress the interests of a particular group to benefit another fall outside of what the compensation incentive can achieve as a governance tool.

Before the paradigm shift in the executive pay debate, circa 1990, rent extraction was clearly a problem, but the extent to which managers could do this and the lengths they would go through were a lot less because the sums of money on the table were significantly smaller. With the introduction of the optimal contracting approach and high-powered compensation incentives, a whole new set of problems of a much larger magnitude are introduced into corporate governance. Performance incentives are geared towards solving the issue of excessive pay but only in relation to performance by justifying high levels of pay as long as performance is improved. This approach fails to address the propensity of managers to extract rents from the

firm. In fact, high-powered compensation plans create new avenues for rent extraction of a greater magnitude than before thus creating a new set of problems with respect to managerial power in the firm. Thus the governance by performance approach that characterizes the intended role of incentive compensation has the potential to magnify the problem of rent extraction and managerial misconduct in the public corporation.

II. A Possible Solution

Looking at the German approach to compensation reform, rent extraction and the propensity of managers to impose the costs of short-term profit seeking onto groups outside the firm can be addressed by placing limits on compensation. The German reform achieves this by articulating a legal standard for the overall compensation amount. Compensation which is inappropriate triggers liability for the Board. This works in conjunction with an interpretation of the corporation's best interests that rejects short-term gains in share price as an appropriate corporate goal. Thus, payment of large bonuses for high levels of share price appreciation, despite creating shareholder wealth, triggers liability unless the corporation itself benefits in the long-run.

Such an approach is suitable in the German context because long-term oriented shareholders or patient capital are prevalent. Capital markets are less developed than in the US and market pressures on management are less intense. This equilibrium is an outcome of political choices made by a multitude of political and economic actors.

The latest of these is Germany's repudiation of the European Takeover Directive, partially insulating German corporations from short-term value creating corporate takeovers. The remaining challenge in the US is the myopia generated by capital markets amongst investors which militates against long-term investment horizons, even amongst pension funds traditionally thought to pursue long-term strategies for the benefit of the labour constituency they supposedly represent.

However, with the articulation of a clear standard for inappropriately high executive compensation and enhanced mechanisms to pursue such claims, long-term oriented shareholders in the US might be inclined to keep managerial power in check. Legally limiting executive compensation in conjunction with a longer-term articulation of corporate purpose could begin to

address the extreme short-termism which led to the crisis. In practice, this could mean that current market value would be insufficient to justify large payments to executives. Alternative indicators of long-term performance might be necessary as a basis for calculating compensation.

III. Answer to Question 2

Constraining risk in the firm requires shareholders to make concessions in immediate performance meaning that they must give up higher short-term returns for the sake of sustainable long-term value. This would mean that some strategies and behaviours which typically benefited some investors, those seeking high short-term returns on the market, are now off limits. Yet it is unclear how an incentive contract, the premise of which is based on providing managers with incentives to raise share price, can now be modified not only to raise share price but place constraints on how high share price can be raised in the short-term. This would entail placing limits on the size of compensation that executives could draw from the firm in a given period.

This approach is not popular in the LME context because placing limits on the size of pay could dilute managerial incentives for performance. This was the problem identified by the Jensen and Murphy literature in the first place. Moreover, how would shareholders know whether a company's current market value reflects an adjustment for excessive risk and unsustainable returns? The typical assumption under the optimal contracting approach is that the higher the share price the better the incentive contract is working to reduce agency costs. With the onset of the excessive risk problem, higher share price can now represent excessive risk-taking that is undertaken to drive-up the firm's short-term market value having drastic repercussions in the long-run.

Short of having detailed inside knowledge of management's strategy, shareholders just can't know from share price alone whether compensation incentives are creating the right levels of risk-taking and performance and not too much performance. What is now required of executive compensation in the post-crisis period poses a challenge to the efficient markets hypothesis on which the efficacy of this approach is based. Even if shareholders could discern between share price that was sustainable or too good to be true, their interests are not by any means homogenous. There are short-term investors that stand to benefit extensively from an ex ante bonding device that aligns their interests in extracting short-term wealth from the firm with those of managers who seek to do the same.

The trade-off between short-term versus long-term time horizons that exists in large organizations creates a dynamic that separates the interests of the entity itself as an ongoing concern and the prerogative of a few of its constituents to derive benefits at the entity's expense. Some shareholders in fact might be comfortable with excessive levels of risk that pose a threat to the firm's long-term viability because their investment horizons are very short-term, their risk is highly diversified, or the potential pay-off is large enough to compensate for their prospects of failed risk. Improving mechanisms that better align managerial behaviour with the demands of shareholders trading on the capital market seems counter-intuitive to constraining short-termism and excessive risk. Certain shareholders through their market power could support compensations incentives that enable them to extract short-term gains at the corporate entity's expense.

The assumption that most shareholders seek long-term sustainable returns in the context of a global market economy dominated by finance and will discipline managers for creating short-term returns that are in effect too high due to excessive risk-taking and unsustainable strategies, is at best unsubstantiated. Corporate law scholarship has raised the argument that shareholders in the widely held public corporation suffer from a collective action problem and lack an incentive to discipline managers. Why then would any shareholder discipline a Board if short-term returns begin to climb to high but potentially unsustainable levels when they can simply exit the investment? By giving shareholders a voice without any objective standard for constraining risk and curbing short-termism they run the risk of approving compensation plans that further contribute to the pursuit of short-term profits. As long as share price remains as the predominant signal that managerial power is being adequately constrained in the firm, shareholders could rubber stamp compensation schemes that encourage excessive risk.

The term optimal contract is re-evaluated in the post crisis law and economics literature to be synonymous with performance which has been adjusted for risk and short-termism, taking for granted that such new norms might in fact call on directors to approach corporate governance not as the agents of shareholders but as the agents of the corporation. However, the role of directors in this post-crisis literature is rather limited to ensuring that this ex-ante bonding device between executives and shareholders is properly negotiated and competently devised. Taking into consideration systemic risk, requires that directors look at a wide range of interests and exercise a higher level of discretion in how these interests are balanced in order to serve the best

interests if the firm over the long-run. This in fact is what post-crisis regulatory responses to executive pay entail and the responses in some jurisdictions call forth a need to account for how corporate power impacts taxpayers and other corporate constituents. Yet the optimal contracting approach and shareholder primacy more generally views managerial discretion and the consideration of non-shareholder interests as a source of agency costs and as a principle reason for why compensation incentives are not high powered enough to create the requisite level of share value.

IV. A Possible Solution

It is clear that the German approach requires directors, on penalty of increased liability, to place the interests of the corporate entity ahead of shareholder profits. This is achieved through several tools, namely a limit on the size of compensation and an articulation of legitimate corporate purpose based on the corporation's interests as an ongoing concern. Thus, directors could be held liable for and required to pay back inappropriately high pay which rewards even the highest gains in short-term share price if they fail to benefit the corporation.

While incentive compensation is still permitted to make up a large portion of the overall arrangement, a notable feature of the legislation is the requirement for directors to limit pay when extraordinary developments occur. Thus if market fluctuations or an exogenous event, such as a takeover, drives up current value, directors cannot permit the executive to benefit from the full extent of the short-term gain in value. This reduces any incentive to manipulate earnings or to place short-term earnings ahead of long-term value. This approach demonstrates that controlling the size of pay is essential to producing a sustainable management orientation.

Another key feature is the requirement to create long-term incentives. This entails using restricted stock options which cannot be exercised until a set period has elapsed after the executive's term on the Management Board is complete. This means that executives could wait several years from the date of vesting to exercise their options. This ensures the executive is held responsible for long-term negative developments that arise from short-sighted decisions made during their term. Several US scholars have proposed this as a viable option in the US context. However, it has yet to be adopted there. A key difference between US and German approaches is that the German corporate statute mandates such long-term incentives. The proposed US approach on the other hand relies on the directors to voluntarily adopt such incentive contracts.

This again is premised on the belief that current market forces will militate towards such an outcome.

Finally, the German approach implements several non-financial criteria for assessing firm performance. These criteria guide directors in assessing the appropriateness of pay and in determining when to reduce pay in response to the situation of the company changing. When assessing appropriateness, directors must look at the Management Board compensation in relation to front-line worker pay, amongst other things. When assessing the situation of the company with a view to exercising the requirement to reduce pay, directors must take into account the company's ability to maintain current employment levels.

CHAPTER THIRTEEN:

Conclusion

The goal of this work from the outset was to relocate the executive pay issue outside the confines of agency theory and explore the broader dimensions of this debate from the standpoint of corporate legal history and political economy. While the debate within agency theory over how to define and approach the problems associated with excessive compensation and poorly functioning incentives occupied the dominant discourse leading up to the crisis, the extreme short-termism and excessive risk-taking which contributed to the collapse of Wall Street firms has challenged the efficacy of the market-based governance model at a global level.

At the national and supra-national level, the need to bring firm management in line with sustainable, long-term governance practices has been at the center of post-crisis governance reform. As examined, post crisis responses to compensation reform and the underlying goals identified represent a shift in governance thinking of a magnitude which entails placing limits on risk-taking and the profit motive in large public companies.

The approach taken in LME countries, namely the US, in many ways fails to recognize the significance of this shift in thinking and what it entails for governance moving forward from the crisis. The ongoing debate over compensation reform in the US is framed from an agency theory perspective which accepts shareholder primacy's efficacy and unproblematic continued existence. This entails the same intensity of reliance on capital markets and performance-based

governance norms as before. Proponents of this model continue to argue that global responses to the compensation problem are rooted firmly within this paradigm, intimating that convergence of corporate governance to a liberal market based model persists. However, we examined several indicators that the crisis has called into question various aspects of this approach.

Yet the failure of agency theory and the optimal contacting model to deliver as promised and the subsequent criticisms of this governance orthodoxy, does not address what sustainable governance entails and whether shareholder primacy is equipped to accommodate a shift to long-term sustainable governance. To explore the former, a review of how corporate law has evolved since the Great Depression, and the executive pay issue within it, was a necessary undertaking, as was a comparative approach. Such an enquiry demonstrated the complexity of such a question and how a longstanding debate over the issue has evolved over time. Comparative political economy assisted us with understanding what precipitated this shift from a legally grounded organizational model of the corporation to a market-based model which has reduced this debate to a choice between constraining director's discretion and increasing market forces on the Board on the one hand and essentially leaving them as they stand and introducing better compensation practices on the other.

While the former model has been vociferously challenged by director primacy theorists and for many reasons appears to be unsuitable for effecting long-term, sustainable governance, it has also been rejected, albeit implicitly, in the context of post-crisis compensation reform. This leaves director primacy and the premise that existing market forces lead to optimal governance arrangements as the remaining model on which reform is to be based.

Yet, restructuring compensation incentives to better align shareholder and manager interests is unsatisfactory at best. After assessing what increasing shareholder power would result in, we asked the question what existing directorial discretion and capital market forces have led us to. Relying on alternative explanations to how markets and their supporting political and legal frameworks impact management orientation, namely the politics of finance approach, but also the critiques advanced by progressive scholars, demonstrates the dichotomous effects of such an approach on societal welfare. Thus, if capital markets coupled with existing directorial discretion have led us to unsustainable short-term management orientations, how can we base our approach to compensation reform on such a framework?

Agency theory and shareholder primacy paradigm served a necessary function in addressing the problem of managerial slack and stagnation in large public corporations in the 1980s during the transition from a corporatist political-economic model to a liberal market model dominated by finance. To a certain extent, this transition was inevitable. However, empirical evidence demonstrates the costs of such a regime on societal welfare.

However, the more provocative claim is that such a regime is unsustainable and prone to implosion, as the latest financial crisis has demonstrated. The debate over executive compensation and the global reform agenda identified after the crisis demonstrates that this model has gone too far. Understanding what the organizational model of the firm and corporate law originally sought to achieve, helped us to uncover how these functions have been undermined by the current approach's focus on improving efficiency, risk-taking and the pursuit of profits. In many ways, the essential functions served by corporate law conflict with the market-based governance approach. Yet, the question raised is whether the benefits of this approach to solving one aspect of managerial power will be undermined by constraining risk-taking and the profit motive. Couched in the language of agency costs, the current orthodoxy stands firm on the belief that any deviation from the shareholder value norm and the consideration of outside interests is detrimental to effective governance.

Yet, recent work in the area of comparative political economy demonstrates that while market forces strongly influence management orientation, they can be resisted by Boards of Directors in favour of a longer-term, stakeholder inclusive approach referred to as the 'high road' to economic production. How then to reform executive pay in the LME in a manner consistent with such an approach? The German response to compensation reform shows not only a repudiation of the market-based approach, in favour of a legal one, dispelling the claim that convergence of corporate governance persists in the post-crisis context, but that the corporate entity must be placed ahead of shareholder wealth maximization. In many ways the German response has crystallized into a rejection of shareholder value and market based criteria.

The main attribute of such an approach has been a constraining of the business judgement rule, but not in favour of increased shareholder power. Instead the German approach imposes stakeholder-based norms of conduct which are tied to the long-term success of the corporation not only as a vehicle for profit but as a vehicle for improving constituent welfare. This highlights

the need to carefully re-assess the balance between profit maximization and the need to constrain risk and consider the interests of other groups tied up with the firm's success.

This raises a much broader question, for a business corporation to be sustainable in the first place, can its purpose be defined as solely to make a profit for its shareholders or is its inherent nature such that it must take other interests into account more readily than the current approach permits? While this work has begun to answer this question, much more needs to be done. However we choose to undertake this, comparative political economy and an appreciation of corporate legal history are essential to subsequent studies of the topic, as confining ourselves to the boundaries of agency theory has been ineffective so far.

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